FOR AGENDA

SM/10/115

May 7, 2010

To: Members of the Executive Board

From: The Secretary

Subject: **2010 Report on Risk Management**

Attached for consideration by the Executive Directors is the 2010 report on risk management, prepared by the Advisory Committee on Risk Management (ACRM), which is tentatively scheduled for discussion on **Wednesday, May 26, 2010**. Issues for discussion appear on page 25.

The staff does not propose the publication of this paper.

Questions may be referred to Mr. Andrews, FIN (ext. 38318) on financial risks; Ms. Mateos y Lago, SPR (ext. 37219) on strategic and core mission risk; and Mr. Bonzi, OIA (ext. 38304) on the ACRM Secretariat and operational risks.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

2010 Report on Risk Management

Prepared by the Advisory Committee on Risk Management

May 6, 2010

Contents **Page**

I. INTRODUCTION

1. **This report presents an overview of the main risks currently facing the Fund, as assessed by the Advisory Committee on Risk Management (ACRM).**[1] The previous report (SM/09/44, 2/13/09) of the ACRM was discussed by the Executive Board in March 2009 and an informal briefing on risk management took place in February 2010.

2. **Following the Board discussion of the 2009 Report on Risk Management, the ACRM explored a number of changes to strengthen the Fund's risk management framework.** This exploration considered suggestions made by Executive Directors (BUFF/09/42, 3/12/09) and a review of risk management practices at other international financial institutions (IFIs). The changes implemented by the ACRM focused on: risk categorization, risk assessment techniques (e.g., use of surveys, interviews), incident reporting mechanisms, and key risk indicators (KRIs).

3. **The 2010 assessment of risks took place in an improved, but still uncertain, global economic environment and at a time when the Fund's mandate is under active discussion.** While the Fund's relevance has been demonstrated by a crisis response that has included financial arrangements with member countries, the institution's more prominent role has also had ramifications for its strategic, financial and operational risks:

- Strategic risks shifted from risks associated with addressing members' immediate needs stemming from the financial crisis, to the risk that IMF reforms will stall, jeopardizing the Fund's continued ability to meet its members' needs. These risks were also influenced by the need to respond to far-reaching calls for policy advice (e.g., G-20 Mutual Assessment Program, Early Warning Exercise) and a strengthened surveillance framework.

- Financial risks were affected by the sharp increase in credit and total commitments, while liquidity risks and income risks have generally receded.

- Operational risks have increased in some areas. On country program work, most arrangements are performing well, but the situation remains precarious in a few individual cases. Operational risks related to HR and staffing (both the size and skill mix) and IT-related risks remain a concern. HR risks related to the downsizing, which were prominent in previous years, have diminished.

---

[1] The ACRM is chaired by Mr. Zhu and includes senior representatives drawn by rotation from each of the three main areas of the Fund (area, functional, and support services departments)—currently APD, MCM, and TGS—and senior representatives from EXR, FIN, HRD, SPR, and OIA who serve in an ex officio basis. OIA serves as the secretariat to the Committee.

4. **This report is organized as follows.** Section II describes recent developments and changes to the risk management framework. The subsequent sections present the main results of the 2010 risk assessment, note changes to perceived risks over the last year, and identify current, or planned, mitigation measures. In particular, Section III provides an overview of the Fund's risk profile, while Sections IV and V lay out the main strategic and financial risks respectively. Section VI discusses operational risks pursuing in more detail certain aspects. Finally, Section VII presents some issues for discussion.

II. RECENT DEVELOPMENTS IN THE RISK MANAGEMENT FRAMEWORK

5. **The Fund's risk management framework was introduced in 2006 and is broadly based on enterprise risk management (ERM) principles.** Executive Directors saw value in introducing a systematic exercise for gathering, synthesizing, and reporting information on risks and controls throughout the Fund. This exercise would promote active risk management and review results of risk self-assessments conducted by departments. Since then, this risk assessment exercise has been conducted annually and reported to the Board (see Box 1).

6. **During the March 2009 discussion of the Report on Risk Management, Directors made suggestions to further improve the Fund's risk management framework** (BUFF/09/42, 3/12/09). These suggestions focused on: (i) the need to ensure that value added of the process is optimized, including by reducing reliance on survey methodology; (ii) the possible use of more advanced techniques, including a more dynamic risk assessment, the use of risk indicators, and the identification of concrete measures to address each specific type of risk; (iii) a review of the modalities of the Fund's risk management framework; and (iv) some interest in a clearer statement from management of its assessment of the balance of risks, the linkages and trade-offs among risks, the efficacy of mitigation measures in place, and the appropriate degree of risk tolerance for the Fund. Subsequently, the ACRM explored changes to help address these suggestions. The Committee was also informed by a review of risk management practices at other IFIs, including the results of a risk management forum organized jointly by the Fund, the Inter-American Development Bank (IDB) and the World Bank in mid- May 2009 and attended by a total of 14 IFIs (see Appendix I). (The 2010 IFI Risk Forum will be held in mid-May 2010.)

7. **Building on the experiences of other IFIs and to better tailor risk management practices to Fund's circumstances, three changes have been, or are in the process of being, implemented.** One, risk categorization has been modified to eliminate overlaps, while avoiding gaps. Two, reliance on surveys has been reduced to make the process more cost-efficient. Three, an incident reporting mechanism and KRIs are being developed. The External Audit Committee (EAC) in January 2010 appreciated progress in these areas and undertook to follow up in its closing FY 2010 report (EBAP/10/5, 1/15/10). These changes were also presented to Executive Directors at the informal briefing on risk management in February 2010. Specific changes are described below in more detail.

Box 1. The Fund's Risk Management Framework

The Fund's risk management framework was established in 2006 following extensive work by a Task Force and various discussions with Executive Directors.[1] The Fund's framework uses the ERM concepts promulgated by COSO.[2] As part of this framework, the ACRM was established to assist Fund management in: analyzing, synthesizing, and reporting risks; enhancing the awareness in departments of risk management; and reporting to the Board on risk management matters.

The Fund's risk management framework incorporated four risk categories:

- **Strategic risk**—The risk that the definition of its medium-and longer-term objectives and formulation of its strategies does not meet the evolving needs of the Fund's membership.
- **Core mission risk**—The risk that the Fund will not achieve its core mission objectives, including macroeconomic and financial stability in member countries, promoting international macroeconomic cooperation, contributing to debt and development initiatives in low-income countries, and providing capacity building services.
- **Financial risk**—The possibility of direct or indirect loss or other negative effects on the Fund's financial position arising from risks including in the areas of credit, income, liquidity and investment.
- **Operational risk—**The exposure of the Fund (and individual Fund organizational units) to direct or indirect losses or negative effects, including reputational, resulting from failures or inadequacies in business processes, people, or systems, or from external events.

Reputational risk, which is of key importance to the Fund, was not included as a separate category but rather implicitly covered in the four other categories, as it can materialize as a consequence of adverse events in any or all of the other risk categories. Compliance with national legislature and regulatory requirements, which is typically included among the four broad risk categories, was deemed less material to the IMF. Therefore, it did not merit a separate risk category, but instead is covered under operational risk.

Annual assessments of risks have been conducted to: (i) inform management and the Board of perceived residual risks by departments, after taking account of mitigation measures; and (ii) apprise departments of risks and efforts to mitigate risk in other areas of the Fund.

Annual reports on risk management were discussed by the Executive Board in 2007 and 2009. In addition, since 2007 updates, informal briefings and interim reports were prepared, including in 2008 on risks of the downsizing and associated restructuring.[3]

---

[1] *Report of the Task Force on Risk Management* (EBS/06/4, 1/09/06 and BUFF/06/24, 2/06/06), *Second Report of the Task Force on Risk Management—Task Force Proposals on the Implementation of a Risk Management Framework at the Fund* (EBS/06/74, 6/26/06), *Statement by the Managing Director on the Second Report of the Task Force on Risk Management* (BUFF/06/07, 6/19/06), and *Risk Management—Further Considerations* (SM/06/386, 12/04/06).

[2] ERM (Enterprise Risk Management) is an integrated framework to manage risks across the organization, and COSO (The Committee of Sponsoring Organizations of the Treadway Commission) is a leading organization in risk management.

[3] *2007 Report on Risk Management* (SM/08/90, 03/06/07, BUFF/07/42, 03/23/07 and BUFF/07/65, 05/04/07), *Report on Strategic and Core Mission Risks in the Fund* (SM/07/90, Supplement 1, 03/09/07), *Report on Financial Risk in the Fund* (SM/07/90, Supplement 2, 03/09/07), *Risk Management—Update* (FO/DIS/08/7, 01/16/08), *Risk Management—Interim Update* (FO/DIS/08/53, 06/02/08, and BUFF/08/79), and *2009 Report on Risk Management* (SM/09/44, 02/13/09, and BUFF/09/42, 03/12/09).

Risks categorization and risk assessment techniques

8. **Core mission risks have now been distributed into the strategic and operational risk categories.** Since 2006 the Fund employed four risk categories in its ERM framework (see Box 1). The core mission category touched simultaneously on the Fund's strategic direction—medium-and longer-term objectives of meeting members' needs—and on the Fund's operations—how the Fund manages, in the near term, its relations with members (i.e., bilateral surveillance, lending, and technical assistance). As far back as 2006 some Directors thought that the strategic and core mission risks should be considered together (BUFF/06/24, 2/6/06). Experience, particularly with the 2009 assessment, revealed considerable overlap between these risk categories. To eliminate this overlap, near-term aspects of core mission risk are now covered under operational risks, while longer-term aspects are included under strategic risks. Recategorization of these risks facilitates the analysis and reporting by presenting a more integrated view of the issues. The risk categories now are: (i) strategic; (ii) financial; and (iii) operational risks.

9. **The risk assessment approach has been streamlined by eliminating self-assessment surveys by all departments and new mechanisms were explored to modernize the ERM techniques.** The 2009 Report included a discussion of strategic risks prepared by SPR and financial risks prepared by FIN; the same approach is followed this year. The 2009 assessments of core mission and operational risks were based on a comprehensive survey carried out by 22 departments and offices. While this approach provided a broad view of the Fund's risk profile (including some scoring of likelihood and impact—see Box 2 of SM/09/44), the survey technique was considered to be too resource intensive by many at a time when staff was under pressure to deliver higher priority tasks related to the Fund's response to the global financial crisis. Questions were also raised by some ACRM members whether the Fund was receiving sufficient "value for money" with the survey; annual surveys could lead to increasingly pro-forma responses by departments, particularly if risk profiles shifted little from year to year. In addition, and as previously indicated, some Executive Directors expressed the view that the Fund's approach relied excessively on surveys. It was recognized, however, that both surveys and interviews could suffer from self-assessment bias.

10. **In most risk management frameworks, following an initial overall assessment of risks, subsequent assessments focus more on annual changes in the environment facing the organization and new processes/products/markets**.[2] In line with focusing on changes, the assessment of 2010 risks took as a starting point the 2009 risk assessments. Information on changes to these risks and new risks was then gathered from a number of different sources. These sources included inputs from bilateral interviews by the ACRM with five department heads (EUR, EXR, OBP, RES, and SPR), and findings from an incident reporting exercise

[2] Organizations typically establish the initial risk profile through a process of risk or risk-control assessments. Depending on the approach chosen, this can be a very time consuming and costly undertaking. An alternative approach is to use a risk survey, which was adopted by the Fund.

(see below).[3] These techniques helped the ACRM to identify an initial list of potential risks, intended as a basis for more focused and in-depth reviews/drilldowns. Finally, all departments reviewed this paper, while in draft, providing a Fund-wide check on the assessments and full coverage of activities/risks.

11. Two other initiatives examined by the ACRM were the development of an Incident Reporting mechanism and Key Risk Indicators (KRIs):

Incident reporting

12. **Incident reporting mechanisms are recognized as key elements of risk management frameworks.**[4] Formal incident reporting mechanisms advise managers of significant incidents that occur, enhancing an organization's ability to draw lessons from failures in key controls and share widely problems and solutions. Incident reporting provides a snapshot of past problems (a lagging indicator). In contrast, KRIs provide coincident and leading indicators. The Fund already has different channels for reporting incidents; however no formal mechanism existed to regularly analyze reported issues, to draw lessons from the past, and to determine whether or not additional action might be needed to address residual risks.

13. **A pilot incident reporting project was conducted in early 2009 and a first exercise was completed in September 2009.** This exercise utilized formal interviews conducted by the ACRM with six department heads (AFR, FIN, HRD, MCM, TGS, and the CIO) and with the advisors to the Managing Director and Deputy Managing Directors. A report was presented to the ACRM for consideration. Incidents were classified as: (i) serious; (ii) less serious; and (iii) near misses. (Box 2 presents the definitions and examples of incidents.) Wider operational risks facing the institution were also discussed.

14. **The September 2009 exercise helped update the Fund's risk profile and identified areas for improved incident reporting.** However, a number of limitations were revealed: one, incidents may have been missed due to incomplete memory or the narrow coverage of Fund activities.[5] Two, the expansion of interviews to all departments and offices can not be achieved without dedicating more resources. Three, conceptual questions were also raised on

[3] OIA also participates on the Oversight Committee to the Integrity Hotline, which meets periodically to review allegations and follow-up and disposition as warranted. Confidentiality and anonymity of any individual providing information is preserved.

[4] The COSO framework indicates that: "All identified deficiencies that affect the entity's ability to develop and implement its strategy … are reported to those positioned to take necessary action. Where findings cut across organizational boundaries, the reporting should cross over as well. Not only are reported transactions or events investigated and corrected, but potentially faulty underlying procedures also are reevaluated."

[5] Incidents happen anywhere in the institution, and thus full coverage would only be achieved if reporting were expanded to also include the 24 Offices of Executive Directors.

the definition of incidents. Four, the Fund—like other organizations—will need to adopt a culture that embraces formal reporting in a transparent manner.

Box 2. Incidents

Incidents can be defined in many ways. Financial organizations that conduct many transactions typically include a monetary threshold in the definition that is used, with thresholds ranging from small to very large monetary amounts, depending on the overall size of the organization and number/value of transactions. Thresholds frequently have been set taking into account information on risk/loss tolerance levels determined by management and boards. For organizations with fewer transactions it may be less meaningful, or not necessary, to set monetary thresholds.

The term incident as adopted by the ACRM is defined as *any failure in people, processes, technology, or external events, which caused, or if not discovered could have caused, a significant disruption in operations, damaged reputation, or led to financial loss or unbudgeted costs.* The difference between serious and less serious incidents is a matter of degree, with serious incidents expected to be reported to management and/or the Board, while less serious incidents could be dealt with on a department basis. Near misses are events characterized by a pre-emptive action that averted what would, or could otherwise have been, a serious or less serious incident.

Examples of serious incidents that were brought to the attention of the Board since the 2009 Report on Risk Management include the error in certain debt data published by the Fund for Eastern European countries and the e-mail outage on which the Board was briefed in November 2009. Examples of less serious incidents were: a twenty minute loss of desk phone service for 50 percent of HQ1, and personnel issues related to staff on leave without pay. An example of near misses was the internal review of the statistical appendix to the GFSR which revealed a number of errors not previously detected, which were rectified prior to publication. Mitigation measures were put in place for all of the incidents.

15. **The ACRM has sought to refine incident reporting to address these limitations.** To enable a more comprehensive approach the number of departments covered will be expanded somewhat and a combination of interviews and written reports will be used. Logs—to be used by departments as memory aide—will be encouraged, but on a voluntary basis. The reporting frequency will depend on the seriousness of the incident (e.g., serious incidents will continue to be reported to management as they happen); otherwise, interviews will be conducted every six months. Information from other reporting mechanisms will also be considered. Periodically the ACRM will review the inventory of incidents to identify the emerging risks, consider the mitigation plans that are in place, and update the risk profile.

Key risk indicators

16. **The ACRM has also endorsed the development of key risk indicators.** KRIs, also called early warning indicators, are metrics used by many organizations to signal that the risks associated with certain key controls or processes may be changing in nature or scale. By measuring deviations from established norms, these metrics provide signals of potentially developing risks and help identify evolving problems. KRIs are usually based on leading indicators and so are considered a forward-looking risk management tool. KRIs need to be analyzed carefully as historical trends are not always reliable predictors of future events. The

development of KRIs is a dynamic and iterative process, and to be fully effective they need to target specific operations and risks of the institution.[6]

17. **A preliminary list of KRIs is currently being developed.** The implementation of KRIs in the Fund will need to overcome two initial challenges: data availability and relevance. To minimize resource costs and to move quickly, departments have been requested to put forward readily available and measurable indicators based on five criteria (see footnote 6). They have also been asked to specify the main risks associated with each indicator. It must be recognized that these indicators are preliminary and experimental in some cases. (Among the preliminary KRIs are: Article IV consultations delayed by more than one year; programs with delayed reviews; precautionary balances as percent of projected credit outstanding; status of quota and governance reforms; vacancies; turnover and mobility rates; IT incidents.) Departments and the ACRM will need therefore to acquire substantial experience with these indicators before they can be considered reliable KRIs. It is also too early to expect that statistical norms would be established for these indicators. Thus, considerable judgment will need to be utilized in the application of these KRIs.

18. **The initial added-value of this exercise will come from having a Fund-wide picture of emerging or changing risks, and sharing and analyzing these indicators in an inter-departmental forum like the ACRM**. The ACRM also plans to prepare a report for transmission to management on a regular basis. As further experience is gained with the KRIs, it will be possible to determine normative ranges, and to evaluate the predictive powers of these indicators. Additional indicators could also be considered and introduced as new data become available. It will take some period of time before a set of KRIs are fully operational. Directors will be informed of developments in this area in next year's risk report.

III. THE FUND'S 2010 RISK PROFILE

19. **Since the 2009 Risk Report, the Fund's risk profile for 2010 has changed in several different ways.** While the global economy slowly recovers, the Fund's activities are gradually shifting away from the response to the financial crisis to focus more on exit strategies from the policies adopted during the crisis and concerns about advanced country sovereign risks. At the same time, the Fund is helping to lay the foundation for a resilient global financial and monetary architecture, and is developing innovative tools to support its operations. This section provides an overview of changes affecting the Fund's main risks, while the subsequent sections provide additional details.

- **Strategic risks shifted and are more prominent as expectations have increased.** As the Fund's role is gradually changing with a lessening of the immediate needs

[6] The development of KRIs also follows a set of principles. To ensure selection of meaningful indicators, they should be: relevant, non-redundant, measurable, easy to monitor, and verifiable.

stemming from the crisis, the risk is shifting to the possibility that the IMF reforms will stall jeopardizing the Fund's continued ability to meet its members' needs.

- **Financial risks have shifted significantly.** Credit risks have increased as lending has more than doubled and total GRA commitments reached a new peak. Progress in the adoption and implementation of the income model, and higher lending income have lowered income risks. New borrowing and note purchase agreements have also reduced liquidity risks.

- **Operational risks have edged higher with a different profile.** Changes to the Fund's toolkit (e.g., FCL and HAPAs; modernizing conditionality; reform of lending framework for low-income countries), the greater focus on systemic and multilateral surveillance, and the further expansion of technical assistance have transformed risks. Moreover, as the Fund becomes more visible and relevant, reputational risks are naturally heightened. To address temporary demands arising from the crisis, the FY 2011 budget allows the full use of contingencies and carry-forwards, while the structural budget remains unchanged pending the outcome of discussions on the Fund's mandate and options for renovating the HQ1 building.

IV. STRATEGIC RISKS IN 2010[7]

20. **This section provides an overview of strategic risks at the Fund, and describes mitigation strategies.** The Fund faces a variety of strategic risks, some of which have emerged as a result of the global financial crisis. While Fund management, staff and the Executive Board are taking steps to mitigate these risks, residual risks will remain.

21. **Failure to show substantive progress in meeting strategic goals could easily lead to renewed doubts about the relevance of the IMF.** At the Annual Meetings in Istanbul, four strategic priorities were identified:

- A review of the mandate of the Fund, to encompass the whole range of macroeconomic and financial sector policies that affect global stability;

- Assisting the G-20 with their mutual assessment of policies (MAP);

- An assessment of whether further reforms of the Fund's financing instruments, could help address global imbalances by reducing the need for countries to self-insure against crisis by building up large reserves;

---

[7] This section was prepared by Ms. Mateos y Lago and Mr. Van Selm from the Strategy, Policy, and Review Department (SPR).

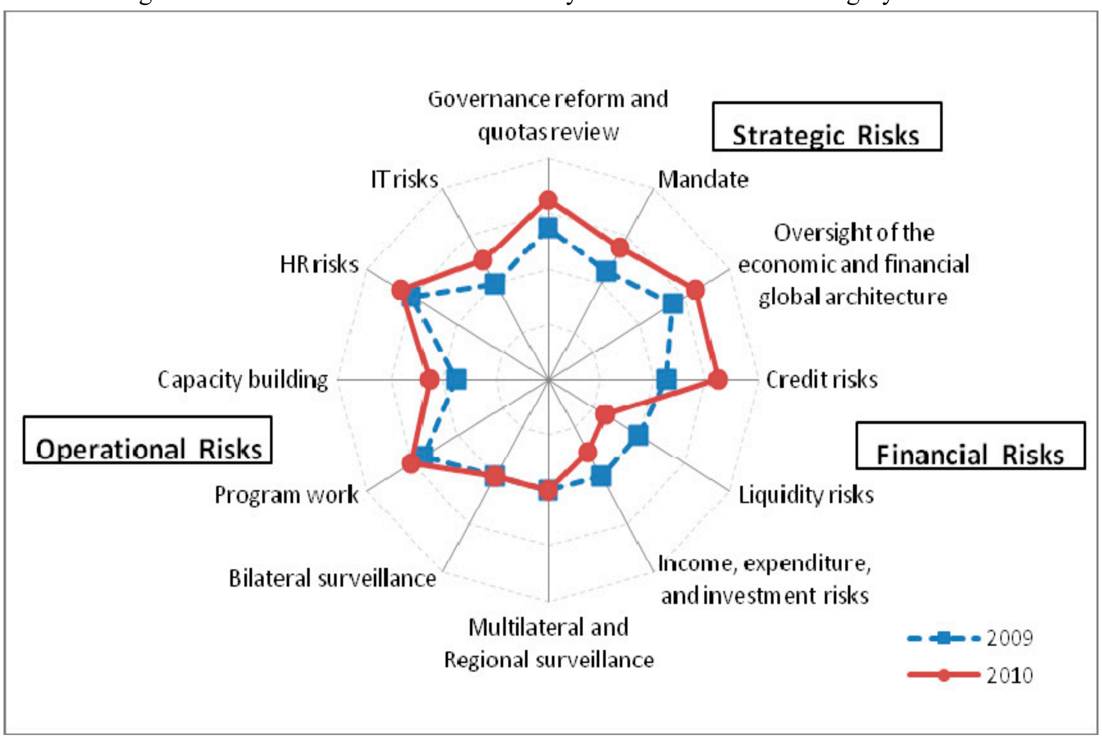
Box 3. The Fund's 2010 Risk Profile

This box aims to provide an overview of the Fund's 2010 risk profile. It is not intended to be a scientific modeling of risks facing the Fund, but rather an illustration of the risk assessments provided in the paper. While drawing upon on the results of the drilldown exercises performed by specific departments, and the analysis presented in the text, this risk map incorporates a high degree of judgment by the ACRM and departments.

This map provides a schematic presentation of the ACRM's assessments of the relative changes in the positioning of various categories of risks in 2010. The 2009 profile draws upon the results of the December 2008 departmental risk survey that were shared with the Executive Board in the 2009 Report on Risk Management (SM/09/44). However, the 2009 risk categorization now reflects that elements of core mission risks have been reassigned into strategic and operational risk categories and the recent modifications of the Key Output Areas (KOAs) into Responsibility Areas (RAs).[1]

The definition of each risk is presented on the next page. It should be noted that the risks covered are very different in nature, address different dimensions, and cannot be measured in a fully consistent manner. The assessments of operational risks, and even more so strategic risks, entail a greater degree of judgment than for financial risks; consequently, those risk assessments proved to be less consensual than that for financial risks, for which quantitative indicators are more available. Also, while some risks are linked to the Fund's outputs activities (e.g., bilateral surveillance, capacity building, program work), other risks (e.g., the HR and IT risks) relate to intermediate processes. These two processed-related risks have been highlighted because they were considered by the ACRM as among the prominent enduring operational risks facing the Fund.

Because of these differences, it should be stressed that the relative positions of risks on the map do not necessarily indicate relatively higher or lower risk levels across categories. Rather, the map aims to illustrate changes in the risks since 2009 as assessed by the ACRM for each category.



[1] *Budget Reforms* (EB/CB/09/3; 12/4/09), and *The FY2011-FY2013 Medium-Term Budget* (EBAP/10/26, 3/29/10).

The map groups twelve risks into three major categories:

- **Strategic risks:** the three risk subcategories address the following aspects:
  - Governance reform and quotas review: refers to the members' request to move forward with governance issues and to deliver on the expected shift in quota shares.
  - Mandate: refers to redefining the Fund's role as a guardian of systemic stability as well as country-level stability.
  - Oversight of the economic and financial global architecture: refers to the role of the Fund in addressing global imbalances and in assisting the G-20 MAP, as well as more broadly change to the international financial architecture.
- **Financial risks:** in providing financial assistance to member countries and conducting its operations, the Fund is exposed to several types of financial risks that have been grouped into three subcategories.
  - Credit risk: the risk that a borrower could fail to meet its financial obligations to the Fund.
  - Liquidity risk: the risk that sufficient resources will not be available to meet the Fund's financing needs and obligations.
  - Income, expenditure, and investment risks: these three separate risks pertain to income (e.g., lending income, donor receipts), expenditure execution (e.g. administrative and capital budgets), and investment (e.g., income and valuation on various investments – PRGT Trusts, SRP, investment account).
- **Operational risks:** the following risk categories have been defined in reference to the Fund's new RAs and to two additional enduring input dimensions.
  - Multilateral and regional surveillance: relates to the operational activities performed in relation to leading the global economic policy dialogue, and strengthening the oversight of the global economic and financial systems.
  - Bilateral surveillance: relates to the operational activities pertaining to advising member countries on economic policies.
  - Program work: relates to the operational activities performed in relation to supporting countries' economic policy adjustments.
  - Capacity building: relates to the operational activities performed in relation to providing capacity building (i.e., technical assistance and training).
  - HR risks: relates to whether the Fund has the proper staffing complement and profile.
  - IT risks: relates to IT services' ability to deliver on new systems and to support new work practices.

This map is presented for the first time and as the Fund continues to strengthen its risk management framework, a variety of qualitative and quantitative techniques, including additional indicators, should help measure more precise risk positions in future risk assessments.

- And moving forward with the quota review and governance issues. The quota review targets agreements on a shift in quota shares toward dynamic emerging markets and developing countries of at least 5 percent from over-represented to underrepresented countries by January 2011.

22. **A series of papers on strategic priorities was discussed by the Executive Board ahead of the Spring Meetings.** In February, the Board discussed an overview paper on the Fund's mandate; in March, papers on realigning quota shares and on IMF governance reform; and in April, on the Fund's financing role, the size of the Fund, progress with the implementation of the G-20 MAP, and modernizing the Fund's surveillance mandate and modalities. The formal meetings were preceded by informal meetings and contacts, with a proactive outreach plan (visits to capitals, meetings with NGOs and academics) used to generate inputs and manage expectations. The strategic priorities cover a wide range of topics, allowing for some risk diversification—progress in some areas will likely proceed faster than in others.

23. **Notwithstanding these efforts, significant residual risks remain.** With the global economic crisis now waning, there is a risk that the strong commitment to international economic cooperation and reform seen during the crisis may evaporate. While good progress has been made on all four strategic priorities ahead of and during the Spring Meetings, difficult decisions—for example, regarding the realignment of quota shares—remain to be taken in the second half of this year. Early indications suggest that finding consensus on Fund mandate and governance issues could prove challenging. Moreover, it is a matter of some concern that the last round of quota and voice reforms has yet to be ratified. As of May 4, 2010, 71 out of the required 112 members, representing 72.9 percent of the total voting power (85 percent is required) have accepted the proposed amendment to the Articles on enhanced voice and participation. If the Fund fails to effectively address legitimacy and relevance issues, its position among other international financial institutions could be weakened.

V. Financial Risks in 2010[8]

24. **Since the time of the ACRM's 2009 Report on Risk Management, the balance of financial risks facing the Fund has moved sharply towards credit risks, while liquidity and income risks have receded.** This section summarizes the recent evolution of these risks and discusses their mitigation.

Credit Risks

25. **Fund lending activity has continued to increase in support of members' response to the global financial crisis.**

[8] This section was prepared by Mr. Andrews from the Finance Department (FIN).

Box 4. Addressing the Key Strategic Risks Identified in the 2009 Report

The Fund has made significant progress in addressing the key residual strategic risks identified in the 2009 report on risk management. In last year's survey-based report, concerns focused on (i) meeting the expectations of the membership to perform in the current crisis and to participate meaningfully in the design of the new financial architecture; (ii) addressing the perception that the Fund's responsiveness to its membership is unbalanced; and (iii) the adequacy of budget resources for carrying out its mandate.

- On (i), the Fund's decisive response to the crisis has won widespread acclaim. The IMF was quick to call for more expansionary macroeconomic policies in the major economies to halt the downward slide. A sharp increase in lending to emerging markets and low-income countries, facilitated by the G-20's decision to triple the Fund's resources, enabled members to implement countercyclical policies. Lending instruments were revamped to better tailor them to the needs of members. Special attention was paid to mitigating the impact of the crisis on low-income countries, including by waiving all interest payments on concessional loans through 2012.
- On (ii), governance reform is a critical element of the Fund's transformation. While quota realignment (discussed above) is obviously a key element, the agenda also encompasses other issues, such as management selection, ministerial engagement, Board composition and size, and staff diversity. A series of Board discussions on these topics has been helpful in clarifying issues and the scope for consensus.
- On (iii), the increase in Fund lending has led to higher earnings from charges and surcharges. Further progress was made toward implementing the new income model, with over half of the limited gold sales now completed. As part of the new income and expenditure framework, the FY 11–13 Medium-Term Budget (MTB) brings to a close a three-year restructuring exercise that began with the FY 09–11 MTB, delivering on promised savings of US$100 million in real terms in the structural administrative budget.

- **The Fund has committed resources at a record pace, using its reformed GRA toolkit.** To better combat current and future crisis, new lending tools were created, especially the Flexible Credit Line (FCL), and existing ones modified (SM/09/60, 3/13/09 and SM/09/69 Supplement 1, 3/19/09). Access limits were doubled, and access has been more front-loaded than in the past and used to a greater extent for budget support. Since the last review, the Fund commitments under the GRA more than tripled to a new record level of about SDR 110 billion in late April. In addition to the amounts committed under 21 Stand-By Arrangements (SBAs) and two Extended Arrangements, this total includes SDR 52 billion under three FCLs. Board approval of the proposed SBA for Greece would increase these commitments by SDR 26.4 billion and commitments could go higher in the event of contagion. (For an assessment of the very substantial risks to the Fund, and effects on Fund liquidity, see EBS/10/77, Supplement 1, 5/6/10.)

- **Credit outstanding has more than doubled**, reaching over SDR 41 billion by end March 2010. Assuming full disbursement of scheduled drawings under non-precautionary arrangements approved to date and the proposed SBA for Greece, outstanding credit would peak at around SDR 74 billion in FY 2012. A number of countries remain vulnerable and may need to seek financial support from the Fund.

- **Credit has remained highly concentrated**. The five largest borrowers account for over 80 percent of total credit outstanding. Moreover, if fully disbursed, credit outstanding under each of the three largest SBAs approved by end-April 2010 (Hungary, Romania, and Ukraine) would exceed both the stock of precautionary balances of SDR 7.3 billion at end-April 2010 and the target for precautionary balances of SDR 10 billion. Access under the proposed SBA for Greece would be 3½ times the level of precautionary balances at end-April 2010. Delays in program reviews have also underscored risks in some program cases.

26. **The Fund has in place a comprehensive set of measures to mitigate credit risks**. These include the Fund's preferred credit status, policies on access, program design and monitoring including conditionality, safeguards assessments,[9] remedial measures to cope with the consequences of financial arrears, and the establishment of precautionary balances.

27. **The last review of the adequacy of precautionary balances took place just after the initial surge in lending to address the global economic crisis.** At end-November 2008, the stock of outstanding credit in the GRA had risen to SDR 17.2 billion, and full disbursement of arrangements then approved was expected to bring the stock of credit to a peak of over SDR 30 billion. While Directors agreed to retain the target of SDR 10 billion, initially established in 2002, they stressed that this should be kept under close review. A number of Directors also observed that the target may need to be raised if lending were to expand significantly and remain high.

28. **Despite the rise in credit, precautionary balances have increased only slightly in nominal terms.** At end-April 2010, precautionary balances stood at SDR 7.3 billion, up from SDR 6.9 billion at end-FY 2008. This increase reflected the recent return to positive net income in FY 2009 and the related placement of SDR 154 million to the special reserves. Despite this slight increase, precautionary balances declined markedly relative to credit outstanding, total commitments, and the Fund's credit capacity.

29. **The next review expected to be completed soon after the Spring Meetings will assess the adequacy of precautionary balances, and further develop the framework for setting the target.** The adequacy of the current target will be assessed in light of the increase

---

[9] Safeguards assessments are an integral part of the Fund's lending operations, having been initiated in 2000 after several instances of misreporting of data to the IMF and allegations of misuse of IMF resources. The policy seeks to provide reasonable assurance to the IMF that a central bank's auditing, financial reporting, control systems, and legal structure and independence are adequate to ensure the integrity of operations and minimize the risk of misuse of resources or misreporting of data. Assessments include recommendations to address identified vulnerabilities, and monitoring of central bank safeguards continues for as long as IMF credit is outstanding. The safeguards policy has been subject to periodic reviews by the Executive Board, and the next reviewed is scheduled for July 2010.

in actual and prospective risks since the last review. Building upon the last review, further consideration will be given to how the reserve target is adjusted over time.

Liquidity risks

30. **Despite the record level of commitments, the Fund's liquidity position in the GRA has strengthened substantially.** At the time of the last report, the Fund's Forward Commitment Capacity (FCC) had fallen sharply from historic highs to under SDR 100 billion. Moreover, an analysis of the likely demand for Fund credit pointed to the possibility that the Fund's liquidity could come under strain, with a sharp decline or even exhaustion of the FCC.[10] In response to this risk to liquidity, the Fund bolstered its resources through bilateral loan and note purchase agreements as a bridge to an expanded and more flexible New Arrangements to Borrow (NAB). As a result of resources made available under loan and note purchase agreements and the increase in the number of members participating in the FTP, the Fund's FCC rose to over SDR 169 billion in early May 2010. The proposed SBA for Greece would reduce the FCC by about 15 percent, but liquidity would still remain adequate. The Board approved the amended NAB on April 12, 2010 and now governments of the participants must ratify it.

31. **Augmenting the Fund's liquidity required the adoption of policies to mitigate risks arising from the use of borrowed resources.** The Fund's unique financing mechanism depends crucially upon the ability of members providing quota resources for GRA lending under the FTP to consider these resources as fully liquid international reserves. The Fund therefore maintains a prudential balance of 20 percent of the quota resources available under the FTP that provides a liquidity buffer in the event that FTP participants need to encash their reserve tranche positions.

32. **Recourse to borrowing agreements also required the adoption of additional safeguards to protect liquidity** (SM/09/150, 6/17/ 2009). In particular, these safeguards include a limit of SDR 15 billion on the amount potentially subject to immediate encashment under a single borrowing agreement, and borrowing agreements providing for encashment also allow the Fund to draw on them in the event that another creditor requests early repayment because of a balance of payments need. In addition, to protect quota resources, which provide the greatest assurance of liquidity to the Fund, borrowed resources have been used in a 1:1 ratio alongside quota resources. In line with the Revised Guidelines for Borrowing by the Fund, such borrowing is subject to continuous monitoring by the Executive Board (SM/09/150, Supplement 2).

[10] The FCC is a measure of the resources available for new financial commitments in the coming year, equal to uncommitted usable resources plus repurchases one-year forward less repayments of borrowing one-year forward less the prudential balance.

33. **As foreshadowed in the previous Risk Report, the crisis also had important implications of LICs' financing needs and the adequacy of the Fund's concessional resources.** In July 2009 the Executive Board adopted a comprehensive support and reform package to strengthen the Fund's capacity to assist LICs in the aftermath of the global crisis. As part of this package, the Board decided to mobilize new resources to boost the Fund's concessional lending to SDR 11.3 billion through 2014–15. The Board agreed that additional subsidy resources of SDR 1.5 billion would come from the Fund's internal resources, including use of resources linked to gold sales, with additional bilateral subsidy contributions of SDR 0.2-0.4 billion being sought to complete the financing package.

34. **During 2009 new loan commitments to LICs rose sharply, and loan resources available under the PRGT fell to near record lows.** As of end-January 2010 uncommitted loan resources under the PRGT amounted to only SDR 660 million, and were sufficient to cover expected commitments for only a few months. Against this background, in March 2010 the Board endorsed new modalities to facilitate mobilization of new bilateral loan contributions. Key changes include: an encashment regime to facilitate reserve asset treatment of members' contributions to the loan accounts of the Trust; Trust borrowing through the issuance of notes in addition to traditional loan agreements; and other changes to facilitate loan contributions in SDRs. In late April, 2010, the Executive Board approved the required amendments to the PRGT trust. Prompt consent of all existing PRGT lenders will now be required to make the PRGT amendments effective to support loan resource mobilization. (For further details see SM/10/94, 4/20/10.)

35. **Actions were also taken to mitigate risks to the liquidity of the SDR market.** Since the 2009 Report, one of the Fund's responses to the global financial crisis included general and special allocation of SDRs which increased SDR holdings by SDR 161.2 billion and SDR 21.5 billion, respectively. Staff worked with participants and prescribed holders to expand the SDR voluntary trading agreements to more than double the pre-allocation number and more than 20 times the pre-allocation capacity. While the SDR Designation Plan also remains an effective backstop, it is unlikely to be activated given the current capacity available in the voluntary agreements which totals more than SDR 65 billion. Staff also developed a trading framework to assist in the trading decisions and to promote burden sharing principles across the voluntary arrangements.

Income and expenditure risks

36. **Income risks have declined.** Primarily reflecting higher lending income than previously envisaged, the Fund's near-term income outlook has improved. The increase in lending income is likely to be temporary, but will help to build the Fund's precautionary balances, which are also a source of interest free resources that will mitigate future income risks. Further progress has also been made in adopting and implementing the new income model, with more than half of the limited gold sales already completed. However, the proposed amendment to the Articles of Agreement to expand the Fund's investment authority

is not yet effective. As of May 4, 2010, only 68 out of the required 112 members, representing 73.9 percent of the total voting power (85 percent is required), have accepted the amendment on the expansion in the investment authority of the IMF. Pending approval of this expansion of the investment authority, it has been proposed that gold profits be held within the GRA where they implicitly earn the SDR interest rate (EBS/10/63, 4/14/10).

37. **On the expenditure side, the current discussions of the Fund's mandate may have budgetary implications.** When they are concluded, the Fund's structural budget will be reviewed. Prior to that, the full use of contingencies and carry-forwards from the administrative budget could limit the flexibility to allocate resources to new demands during FY2011. If crisis does not recede as envisaged, or intensifies, budget (work) pressures will be higher than expected. The capital budget could also be affected by the options for renovating the HQ1 building.

Investments

38. **The main risk to the Investment Account under the current restricted investment mandate stems from the possibility of underperformance and possible capital losses in a rising interest rate environment.** Holdings in the Investment Account are limited to securities issued by sovereigns that issue currencies in the SDR basket, and by international financial institutions, while Trust Fund resources are invested in a broader range of assets including deposits in the BIS. In both cases, exchange rate risks are mitigated by holding investments denominated in and weighted according to the constituent currencies of the SDR. Counterparty and exchange rate risks associated with the investment account and balances in the Trusts are also limited. Both portfolios have performed well recently as a result of sustained declines in interest rates. However, the potential risk of future underperformance, were policy rates and bond yields to rise substantially, has also increased. In particular, staff's sensitivity analysis indicates that the IA would underperform the SDR rate if yields follow or rise by more than current forward rates. This highlights the importance of securing prompt approval of the amendment to the Articles of Agreement to expand the Fund's investment authority. Market risks are more material to the Staff Retirement Plan and are closely monitored by the Investment Office and the SRP's Investment Committee—and are mitigated, moreover, by the portfolio's extensive diversification, the strong funded position of the SRP coupled with the budgetary reserve mechanism which serves to limit changes in required funding from the administrative budget.

VI. Operational Risks in 2010

39. **The ACRM updated the Fund's operational risk profile and identified five main operational risks,** taking into consideration: (i) the baseline provided by the December 2008 survey; (ii) the results of the September 2009 incident reporting exercise; and (iii) inputs from the interviews conducted by the ACRM with selected Department Heads in November 2009. In January and February 2010, the ACRM reviewed these risks and emerging trends, and identified five key areas:

- **Country program work.** Risks related to the potential limitations in the design or implementation of Fund-supported programs, and to the challenges originating from managing joint-programs with other institutions.

- **Fund's policy positions.** Surveillance risks, both multilateral and bilateral, associated with the Fund's capacity to analyze current economic issues, produce high-quality and effective policy advice, and support appropriate responses to the global crisis as requested by the membership and the G-20. Higher expectations from the membership, and the public at large, regarding the Fund's role as a crisis-prevention and-resolution institution also entail significant reputational risks.

- **Fund-wide data coordination, manipulation, and reliability.** Risks related to the need to improve data management and controls over data quality, consistency, and comparability, and to ensure an effective and efficient use of staff and IT resources.

- **IT services and systems delivery.** Risks related to IT services' ability to deliver on new systems and to support new work practices against the backdrop of the added pressures stemming from the financial crisis.

- **HR and staffing.** Risks related to whether the Fund has the proper staffing complement and profile to respond to the increased work load and the new demands placed on the institution.

40. **From these five risks, the ACRM selected three for further analysis and mitigation efforts.** The three operational risks selected for drilldown were: (i) the country program work-related risks; (ii) the IT services and systems delivery-related risks; and (iii) the HR and staffing-related risks. The ACRM considered the two other risks were appropriately addressed through ongoing processes, as explained below, hence further drilldown work at this stage would be duplicative and not cost effective.

- **The Fund's policy positions.** Key mitigation efforts include broad oversight (including continuous consultation with shareholders) and a modernized review process. In advance of the Spring 2010 IMFC Meetings, the Board discussed Fund policy positions in a series of meetings, including discussions of the World Economic Outlook, the Global Financial Stability Report, and various seminars on current policy issues (e.g., on capital flows).

- **Fund-wide data coordination, manipulation, and reliability.** Following the discovery of data errors in the published April 2009 GFSR, management set up an inter-departmental working group on WEO/GFSR data integrity. The working group examined data compilation, verification, and production processes for multilateral surveillance in both area and functional departments, and reported to management on June 30, 2009. OIA included in its FY 2011 work program a review of controls over data inputs into the World Economic Outlook (WEO), Global Financial Stability

Report (GFSR), and Regional Economic Outlooks (REO). Seven IT capital projects, making up more than half the Enterprise Information IT capital portfolio in FY 2011, will improve various components of the Fund's data management capabilities. (For further details see EBAP/10/26, Supplement 2, 3/31/10.)

41. **Technical Assistance (TA)-related risks are also relevant but were not included in the five main risk areas, for now.** At the February 2010 informal briefing on risk management, some Executive Directors expressed interest in a review of operational risks stemming from TA activities. The ACRM noted that the rising demand for Fund TA had put pressure on the Fund's capacity to absorb and manage its expansion. Several initiatives have been taken to strengthen the TA governance framework. (For a more detailed discussion see (SM/08/97, 4/3/08), and (EBAP/10/26, 3/29/10.) In addition, OIA is performing a review of the backstopping of TA experts as part of its FY 2010 work program, and plans to include a review of governance over TA-related operations in FY 2011. The ACRM therefore concluded that a separate drilldown exercise was not needed at this time.

42. A summary of the results of the further analysis for the three selected operational risks is presented below:

Country program work[11]

43. **The main program work-related risks for the Fund are credit risk and reputational risk.** While the record of repayment of Fund lending is very good, experience has shown that even a single high-profile program that fails to deliver the expected results can cause significant reputational damage. Since the onset of the financial crisis in October 2008, the Fund has responded quickly and flexibly to requests for arrangements, with 22 new Stand-By Arrangements and three FCLs approved. Credit outstanding has increased sharply but remains highly concentrated. In addition to the financial and reputational risks, some area departments have experienced operational risks from a shortage of Fund-specific knowledge and program experience as a result of the restructuring and the subsequent hiring.

44. **Most programs are performing well, but the situation remains precarious in a few individual cases.** With the global economy recovering, macroeconomic pressures are now abating in many program countries. The multi-country Review of Recent Crisis Programs, completed just ahead of the 2009 Annual Meetings, found that the crisis had a profound impact on output and employment, especially in those countries starting with large external vulnerabilities. But, with greater up-front financing and more accommodative policies, many of the severe disruptions seen in previous crisis—currency overshooting and bank runs—were avoided. Internalizing lessons from the past, programs have responded to country conditions and adapted to worsening economic circumstances to attenuate

[11] This section was prepared by Ms. Mateos y Lago and Mr. Van Selm from the Strategy, Policy and Review Department (SPR).

contractionary forces. Nevertheless there remains a set of difficult country cases, involving very high debt, banking problems or political instability, which may not be fully resolved within the present, or prospective, programs and would need follow-on arrangements. Moreover, several recent crisis programs have resulted in large Fund exposures to members that may require enhanced monitoring for a number of years.

45. **Mitigation efforts to reduce country program work-related risks include**:

- **Broad oversight**: continuous consultations with member authorities and other stakeholders (academics, civil society); and a new cross-country perspective in real time (the Review of Recent Crisis Programs, now being updated for Executive Board consideration). Capacity to repay the Fund is assessed by the Board at the time of each program's approval, and subsequently when program reviews are considered by the Board.

- **Flexibility**: programs have accommodated new developments; streamlined structural conditionality has been conducive to greater program flexibility.

- **Review process**: now modernized, with face-to face meetings replacing paper-borne comments. The Office of Internal Audit and Inspection (OIA) is conducting an evaluation of the new review process.

- **Review of precautionary balances:** held soon after the Spring Meetings; the target for precautionary balances is kept under close review.

46. **Use of Fund resources for budget support is in line with the Fund's mandate and is neither new nor temporary.** Under all Fund programs, members are granted access to resources only if they have a balance of payments need and commit to implementation of a policy framework that helps resolve the underlying balance of payments problem and provides adequate safeguards for use of Fund resources. In cases where budget financing is constrained, yet sustainability and cyclical considerations warrant a countercyclical fiscal response, the use of Fund resources for budgetary support allows for smoother and more efficient adjustment.

47. **The use of the domestic counterpart of Fund resources for budgetary purposes raises at least three concerns from the perspective of adequacy of safeguards to ensure repayment to the Fund.** One, the making of the repurchase may become subject to the budgetary appropriation process. Two, within the time period for repurchase, the government will either have to generate a budgetary surplus in order to be able to purchase the foreign exchange necessary to repay the Fund or borrow it from another source. Three, absent a clear exit strategy, there is a risk that fiscal policy will become unduly reliant of Fund resources to

finance what may be permanent expenditures.[12]

48. **For all programs, the ultimate safeguard for repayment to the Fund is program design.** If a program is well designed and properly executed, this provides the strongest safeguard that the Fund will ultimately be repaid. Should direct budgetary support become increasingly prominent as a form of Fund disbursements, then alternative safeguards will need to be considered, building on existing platforms to strengthen fiscal transparency and accountability, including fiscal ROSCs. In this context, the forthcoming review of the safeguard policy will examine the pros and cons of possibly modifying the safeguards mandate.

IT services and systems delivery[13]

49. **The Fund is undergoing considerable change as it strives to innovate, modernize, and quickly respond to new demands.** The pace of change, combined with budget constraints and a backdrop of added pressures stemming from the financial crisis, creates an elevated level of risk on several fronts. The mitigation efforts to reduce risks associated with delivering the IT services and systems needed by the Fund are concentrated in four risk areas: (i) failure of existing systems; (ii) failure to deliver new systems and work practices within required timeframes; (iii) failure to adequately secure sensitive information; and (iv) poor alignment of IT projects with Fund needs.

50. **While the rate of change to the Fund's IT systems and work practices is increasing, so too is Fund reliance on existing systems.** A prolonged outage of communication services such as email or telephony systems, or the failure of critical systems such as the Fund's financial systems, would jeopardize the Fund's ability to respond to a crisis or meet member country expectations. While mitigation measures are in place, incidents do occur. Lessons learned from IT system incidents are incorporated on an ongoing basis. In this risk area, mitigation strategies are multi-pronged:

- Potential infrastructure failures are mitigated through use of multiple data centers equipped with current, fault-tolerant and redundant hardware, regular business continuity and disaster recovery exercises, and maintenance contracts with defined services levels.

- Risk of application failure is mitigated through maintenance contracts with service providers with defined service levels, and the replacement or refreshment of systems to ensure that they are based on current, supported, versions of software.

[12] Staff was provided operational guidance and background information on the use of Fund resources for budgetary financing in "*Staff Guidance Note on the Use of Fund Resources for Budget Support*" (EBS/10/55, 3/24/10).

[13] This section was prepared by Mr. Palmer from the Technology and General Services Department (TGS).

- Other risk mitigation efforts include: formal change management processes (to ensure that new systems are adequately tested), incident management processes (to promote speedy recovery and reduce the impact of outages), constant monitoring of system performance and availability, regular communication with staff, careful management of workloads, and constant monitoring of system performance and availability.

51. **New systems and associated revised work practices are required within challenging timeframes.** Changes to Fund policies, the pressing need to streamline work practices to cope with resource constraints, and pressures to develop new products and services in response to the financial crisis are driving demand for rapid delivery of major new systems within challenging timeframes. At the same time, departments' capacity to effectively engage in IT projects and cope with changes to work practices is reduced due to staffing reductions and/or the urgency of crisis response work. Mitigation measures include constant monitoring of project status to ensure that problems are detected early, increased emphasis on the application of appropriate systems development and project management methodologies, the strengthening of IT staff knowledge of work practices in client departments, and early identification of the infrastructure and security implications of new systems.

52. **Attempts to breach the Fund's IT systems are growing in number and sophistication.** An external assessment of the Fund's IT security posture in 2009 proposed several measures to improve the Fund's security posture. A major capital project is underway to deliver both procedural and technical security enhancements, as follows:

- A major communication and education campaign will commence in June 2010 to promote awareness and capacity of Fund staff to classify, label, and handle sensitive information with appropriate care. This will reduce the risk of inadvertent disclosure of sensitive information.

- Third-party attacks are mitigated through a variety of technical controls and the constant logging and monitoring of network traffic and system activity. TGS' plans include a significant upgrade of end-point protection, and an increased compartmentalization of Fund systems to make it more difficult for attackers who get in to move from one system to another.

- Willful unauthorized disclosure of sensitive information is primarily mitigated through appropriate disciplinary actions. The introduction of new data loss prevention systems is also planned.

53. **With a tight budgetary environment it is important that the allocation of scarce resources to fund new systems and major system enhancements is well aligned to Fund priorities and needs.** The alignment of the capital program is ensured through: (i) the close engagement of departments in capital planning process through the Portfolio Assessment Teams (PAT) and the IT governance standing committees; and (ii) management's involvement in priority setting and budget formulation through the Committee on Business

and IT (CBIT). The IT governance framework thus ensures both bottom-up and top-down reviews of capital bids and capital plans. Additionally, various initiatives have been taken to foster effective IT staff engagement with key stakeholders, to enhance understanding of business needs.

54. **This IT-related risk mitigation plan is still under development.** The plan was refined at a workshop of senior IT staff in March and an external expert will be engaged to review the plan in May.

HR and staffing[14]

55. **In the period since the 2009 report on risk management, the balance of HR-related risks has shifted somewhat.** The downsizing of the Fund has almost been completed, reducing some HR risks identified in the 2009 report on risk management. The adverse impact on staff morale and the risk that a distracted staff would not be well positioned to meet the operational challenges facing the institution have largely been resolved, ameliorated, or are no longer as relevant. However, other HR risks have increased, including achieving the right skills mix and structure in the downsized environment, achieving diversity in all employment aspects, and managing stress and the risk of error in an environment where work pressures have increased. The Fund's ability to attract and retain staff with the necessary skill set and experience will also be tested as the external demand for the skills and experience needed by the Fund recovers (especially financial sector experience).

56. **HRD convened a workshop with senior managers from all departments to consider the key workforce and staffing challenges facing the institution.** This included an assessment of how the current workforce compares with future needs in terms of size, structure, and skills mix. The workshop provided an opportunity to discuss appropriate mitigation measures for addressing a number of HR/staffing risks. The key HR and staffing risks thus identified are taken up in more detail below, and the mitigation measures in place or planned are outlined.

57. **Achieving the right skills mix and diversity in all employment dimensions.** There is a need for a more appropriate skills mix to meet the Fund's evolving responsibilities (in particular, more economist staff with financial sector expertise). Furthermore, in order to remain flexible and relevant, the Fund needs to progress toward diversity in all employment dimensions, including educational background and work experience, with a mix of short-term and open-ended staff. Mitigation measures include the following:

- HRD is working with departments to achieve the right skills mix to meet the Fund's evolving responsibilities. In 2009, the Fund hired 29 financial sector experts (13 staff and 16 contractual experts), more than doubling the number of hires with such

[14] This section was prepared by Ms. Fennell from the Human Resources Department (HRD).

experience compared with recent years. The Fund also hired a larger proportion of mid-career economists with substantial policy experience.

- Work is underway to develop a corporate workforce plan, which will identify the skills gaps and will be used to guide the direction of the Fund's HR policies, both at the corporate and departmental levels.

- HRD, working closely with OBP, is supporting better workforce planning at the department level. A new tool is being developed and will be rolled out to departments in mid-2010 to help department managers to make HR decisions (for example on hiring and promotions) under the new budget framework.

- HRD is working with departments to review the employment framework, including the desirable mix of short-term and open-ended staff, and also to provide support for decisions on extension or separation of recent hires on short-term appointments, following the wave of hiring.

- The Diversity Scorecard has been launched to monitor progress in achieving diversity goals, diversity is an important consideration in talent reviews, and diversity composite has been introduced in the Staff Assessment of Managers (SAM) exercise.

58. **Excessive staff turnover and mobility on some country teams, and shortage of Fund-specific knowledge and program experience.** Relatively short tenure of economist staff (including mission chiefs) working on some country teams could adversely affect the effectiveness of the Fund's interactions with members and the quality of advice provided to authorities. The African and European Departments drew special attention to these issues. The shortage of Fund-specific knowledge and program experience in some areas also raises the risk of operational mistakes in the design and monitoring of programs and puts increasing stress on experienced staff members, who need to carry their own workload while coaching less experienced staff. To mitigate these adverse effects, recruitment efforts are continued to achieve steady state staffing levels and help reduce staff turnover. HRD is also working with Senior Personnel Managers (SPMs) to develop a policy on and support for internal mobility that would, inter alia, aim to ensure greater continuity. Additionally, better workforce planning by departments will also help to ensure that turnover is managed more effectively.

59. **Staff stress and risk of operational errors in key areas of the Fund's work.** Work pressures are high in the post-downsizing environment, particularly in areas of the Fund where work has increased and the staffing envelope remains extremely tight. To obtain a better sense of staff pressures and identify areas for improvement, a Fund-wide survey of staff views on the work environment, the Fund as an employer, and career development opportunities is planned for later in 2010. The outcome of the survey will provide important input to guide HR policies. Key stress indicators will also be monitored across the Fund (including overtime, sick leave, turnover rates, and vacancy rates). Finally, management will continue to encourage managers to allow staff to make use of flexible work arrangements—

including compressed work schedules (CWS) and alternative work arrangements—which are intended to help alleviate stress and support work-life balance.

60. **The ability of HR to deliver in the current environment.** HRD has already achieved a sizeable staffing reduction, from a budgeted 96 FTEs in FY 2007 to 78 by end-FY 2010 in line with the targeted path for downsizing the department. However, there is a serious risk that a further reduction in HRD to 62 FTEs in FY 2012, as envisaged in the current medium-term budget outlook, would undermine the effective management of the institution's key resource—its staff. Ongoing and planned mitigation measures are as follows:

- Further streamlining and automating of HR processes and transition to a more self service environment (implementation of the HCM project).
- Extend the timeline for implementation of HR reforms (including for example phasing the rollout of APR automation).
- Undertake thorough review of HR functions and the adequacy of HR resources in departments as they seek to implement the wide range of HR reforms.

VII. Issues for Discussion

61. **Executive Director's views are sought on the following issues:**

- Do Directors support the changes to the risk management framework described in paragraphs 7 to 18, including the revised risk categories and assessment techniques?
- Do Directors agree with the risk assessments in this report? Are there any significant risks that Directors find missing in the ACRM report?
- What are Directors' views on the analysis and mitigation measures related to operational risks?

62. **At the time of the introduction of the risk management framework in 2006, it was expected that this framework would be reviewed after three years of implementation.** The ACRM will consider ways to further refine and focus the risk framework drawing on the experience so far, reviews of best practices in other in IFIs, and other organizations, and based on discussions with members of the EAC. Additionally, a review of the Fund's risk management framework by a panel of independent external experts is envisaged. The results of this work will be presented to the Executive Board.

Appendix I. Risk Management Practices at other International Financial Institutions

Risk management practices at other international financial institutions (IFIs) continue to evolve. Some organizations have had comprehensive frameworks in place for a number of years—e.g., the Bank for International Settlements (BIS), the European Bank for Reconstruction and Development (EBRD), the European Central Bank (ECB), and the European Investment Bank (EIB); others have introduced, or are in the process of introducing, different elements of ERM (Enterprise Risk Management) frameworks, the most frequent reference being the COSO framework.

The Fund, the Inter-American Development Bank (IDB), and the World Bank organized in May 2009 a risk management forum, which was attended by a total of 14 IFIs. While numerous approaches exist for delivering organization-wide risk management*,* a key message that emerged from this forum is that risk management must be tailored to each organization's specific needs, and must be based on realistic expectations.

Other key points can be summarized as follows:

- Management (and the Board)[1] play a critical role in driving effective risk management, setting the tone and culture, and resourcing.[2] In the Fund, the Advisory Committee on Risk Management (ACRM) is now chaired by a Special Advisor to the Managing Director.

- Formal risk management policies (describing roles and responsibilities, acceptable risk profiles/appetite/tolerance, etc.) have been widely adopted. The Fund does not have a formal risk policy in place.

- All IFIs conduct annual risk self-assessments, or are planning to introduce them. The detailed approach, and hence the cost, varies across institutions. The departmental risk survey was the Fund's approach to risk self-assessment.

- All IFIs have, or are developing, incident reporting mechanisms and key risk indicators (KRIs). These serve to alert risk managers to control failures or to new or changing risks. The Fund is introducing these techniques in a phased manner.

---

[1] Some organizations use a two-tier Board structure where the supervisory function is performed by a separate entity known as a Supervisory Board, which has no executive functions. Other organizations by contrast, use a one-tier structure in which the Board has both functions. The term Board is used in the context of the discussions of other IFIs to refer to oversight functions as opposed to management functions.

[2] These points were also made by COSO in: *Effective Enterprise Risk Oversight: The Role of the Board of Directors* (2009), and more recently by Basel Committee on Banking Supervision in: *Principles for Enhancing Corporate Governance* (2010).

- Following an initial developmental stage, risk management functions have been separated from internal audit; small central ERM units have been typically established.[3] These units should have sufficient stature and authority to influence decisions that affect risk exposures, including related to new products and activities. The Fund does not have such a dedicated unit, but instead has formed an inter-departmental advisory committee (the ACRM) with a secretariat.

[3] For instance, the BIS has a Compliance and Operational Risk Unit that reports to the Deputy General Manager; the EBRD has a Director of Risk Management with overall responsibility for risk management activity, who reports to the Vice-President for risk management, human resources, and nuclear safety. At the World Bank, an Operational Risk and Control Unit, placed under the World Bank's Controller, supports institutional risk management and prepares an annual integrated risk report.