Risk Management of Finance and Investment Account

The operations of financial institutions involve various risks, including credit risk, market risk, liquidity risk, operational risk and other risks. As a government agency, JICA conducts financial operations to achieve policy objectives. Thus, the nature as well as the extent of risks in JICA's operations and the ways to deal with them differ from the risks and countermeasures at private financial institutions. Nonetheless, it is essential for JICA to have appropriate risk management just as at a financial institution. In line with the global trend among financial institutions and regulators of increasingly focusing on risk management, JICA is constantly improving its risk management of the Finance and Investment Account.

More specifically, risk management of the Finance and Investment Account is positioned as a managerial issue that needs to be addressed systematically by the entire organization. JICA has thus adopted a risk management policy for its operations. Under the policy JICA identifies, measures and monitors various risks. The objective of this policy is to ensure sound and effective operations and to earn returns commensurate with risks. JICA has established Risk Management Committee for Finance and Investment Account that examines important issues related to integrated risk management.

JICA manages various risks associated with Finance and Investment operations as follows.

Credit Risk

Credit risk refers to the potential loss from difficulties or failure to recover credit assets due to the deteriorating financial condition of a debtor. The main area of Finance and Investment operations, which consist of ODA Loans and Private Sector Investment Finance, is lending. Consequently, the control of credit risk is a major part of JICA's risk management. Given the very nature of financial support for external economic transactions and overseas economic cooperation, JICA extends loans to foreign governments and government agencies. Therefore, sovereign risk makes up a considerable part of the credit risk that accompanies ODA loan operations. JICA, as an official financer, evaluates sovereign risk by making full use of information gathered through communication with the governments and relevant authorities in the recipient countries, multilateral institutions such as the International Monetary Fund (IMF) and the World Bank, other regional and bilateral donor organizations, and private financial institutions in developed countries. Private Sector Investment Finance, which was resumed in the current fiscal year, involves both the corporate risk accompanying the credit extended to companies and country risk arising from changes in the foreign currency situation or political and economic condition of the country in which the company is located.

1) Credit Rating System

JICA has established a credit rating system as part of the organization's operating procedures that is to cover all the borrowers in principle. Credit ratings are the cornerstone of credit risk management, being used for conducting individual credit appraisals and quantifying credit risks. Credit ratings are divided into two categories: sovereign borrowers and non-sovereign borrowers. A different credit rating system is used for each category. Ratings are subsequently updated as appropriate.

2) Self-Assessment of Asset Portfolio

JICA performs self-assessments of its loan portfolio to properly reflect the characteristics of its assets based on the Financial Inspection Manual prepared by Japan's Financial Services Agency. The purposes are to manage credit risk and to implement write-offs and loan loss provisions in a proper and timely manner. To ensure an appropriate checking function, in this process, the first-stage assessment is conducted by the relevant departments in charge of lending and investment and the second-stage assessment is conducted by the credit risk analysis department. The results of self-assessments conducted on the asset portfolio are not only used internally for the continuous monitoring of the loan asset portfolio but also reflected in the disclosure of asset quality to enhance the transparency of JICA's financial position.

3) Quantifying Credit Risk

In addition to individual credit risk management, JICA is working on quantifying credit risks with a view to evaluating the risk of the overall loan portfolio. To do that, it is important to take into account the characteristics of JICA's loan portfolio, a significant proportion of which consists of long-term loans and loans to foreign governments and government agencies. Also, JICA takes into account multilateral mechanisms for securing assets such as the Paris Club which is a unique framework for debt management by official creditor countries. By incorporating these factors in the credit risk quantification model, JICA measures credit risks and utilizes it for internal controls.

Market Risk

Market risk refers to the potential losses incurred through changes in the value of assets and liabilities caused by fluctuations in foreign currency exchange rates and/or interest rates. In the context of potential losses stemming from changes in market interest rates, JICA bears risks due to the characteristics of its financing activities, which are conducted over terms that can reach up to 40 years. In this regard, JICA is enhancing its capacity to absorb interest rate risk by using capital injections from the General Account Budget of the Japanese government. Furthermore, interest rate swaps are carried out exclusively for the purpose of hedging interest rate risk. In order to control counterparty credit risk of interest rate swaps, the market value of transactions and credit worthiness of each counterparty are constantly assessed and collateral is secured when necessary.

JICA does not extend foreign currency-denominated loans but, with the introduction of the Japanese ODA loan with Currency Conversion Option in the current fiscal year in response to the requests from borrowers, currency risk arises from the conversion of yen-denominated loans into foreign currency-denominated loans. Consequently, currency risk is hedged through currency swaps. Moreover, when foreign currency-denominated investments are extended in Private Sector Investment Finance, currency risk is assumed in connection with the valuation of investments. JICA manages this currency risk through regular and continuous monitoring of exchange rate fluctuations in the currency of the country in which the counterparty is located.

Liquidity Risk

Liquidity risk refers to risk of having difficulty securing sufficient funds due to a deterioration of JICA's credit or to an unexpectedly large increase in expenditures or an unexpectedly large decrease in revenues.

JICA uses many measures to avoid liquidity risk through management of its cash flow. This includes efforts to secure multiple sources of funds such as Agency Bonds and borrowing under Fiscal Investment and Loan Programs.

Operational Risk

Operational risk refers to potential losses incurred from work processes, personnel activities, improper systems, or other external events. For JICA, this refers to risks that stem from its operations, systems and internal or external misconduct. JICA manages the operational risk as part of the efforts to promote its compliance policy.