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IFAD

Enabling poor rural people to overcome poverty

Level of the General Reserve

Note to Executive Board representatives

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Technical questions:

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Executive Board — 100th Session
Rome, 15-17 September 2010

For: **Review**

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Enabling poor rural people to overcome poverty

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Note to Audit Committee members

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Audit Committee — 116th Meeting
Rome, 13 September 2010

For: **Review**

Recommendation

The Audit Committee is invited to endorse the recommendation on the General Reserve, as contained in paragraph 28.

Level of the General Reserve

I. Background

1. The General Reserve was established by the Governing Council in 1980[1] to meet the potential risk of overcommitment of IFAD resources as a result of:

   - Exchange rate fluctuations;
   - Possible delinquencies in the receipt of loan service payments; and
   - Possible delinquencies in the recovery of amounts due to the Fund from the investment of its liquid assets.

2. In 1999 the Governing Council[2] recognized the need to provide further cover for the Fund against the potential overcommitment risk resulting from:

   - A diminution in the value of assets caused by fluctuations in the market value of investments.

3. At the Reserve's inception, the Governing Council authorized the Executive Board to approve future transfers from the Fund's accumulated surplus up to a ceiling of US$100 million, taking into account the Fund's financial position. In 1999 it modified this position, deciding that the ceiling of the General Reserve could be amended from time to time by the Executive Board. The Board approved several transfers between 1980 and 1994, bringing the Reserve up to its current level of US$95 million.

4. The Executive Board, through the Audit Committee,[3] is required to review the level of the Reserve at least once every three years. The last review was conducted in December 2006. The current review process was begun in 2009 with the objective of presenting this document to the Audit Committee at the beginning of the current year. Because of the Committee's heavy agenda during early 2010, however, it was only possible to schedule the review for September.

5. The Committee is required to review the adequacy of the General Reserve and to report to the Executive Board with its conclusions and recommendations.

II. Risk of overcommitment of IFAD resources

A. General

6. The Agreement Establishing IFAD requires the Fund to exercise prudence in ensuring that the funds committed will be sufficient to meet liabilities when they fall due. Article 7, section 2(b) states: "The proportion of the Fund's resources to be committed in any financial year…shall be decided from time to time by the Executive Board with due regard to the long-term viability of the Fund and the need for continuity in its operations." The underlying implication is that IFAD should be considered a going concern, i.e. it is intended that the Fund will continue its operations for the foreseeable future with no intention or need to liquidate or curtail significantly the scale of its activities.

[1] GC 1980 16/IV.
[2] GC 1999 22/L.9.
[3] See Terms of Reference and Rules of Procedure of the Audit Committee of the Executive Board adopted in September 2009 (EB 97/R.50/Rev.1).

7. Since the 1980s when the General Reserve was established, International Accounting Standards (now largely replaced by International Financial Reporting Standards) have evolved and have introduced more rigorous requirements in safeguarding the solvency of the organization. It is now required that accounting provisions be set up to cover specific risks (e.g. IFAD in recent years introduced provisions for after-service medical coverage, securities lending and cash collateral liabilities) and that an equivalent amount of resources be earmarked and not committed for loans or grants. This lowers the risk of overcommitment of resources.

8. Over the years IFAD has introduced other mechanisms and controls to ensure that the risk of overcommitting its resources is minimized. This includes:

- The review and approval of resources available for commitment by the Executive Board prior to approval of projects;
- The introduction of structured asset liability management (ALM);
- The creation of a separate ALM unit within IFAD Treasury; and
- The detailed assessment of the financial health and resource situation of IFAD at each Replenishment Consultation.

9. Since the Committee last reviewed the adequacy of the Reserve, some additional risks have emerged in the environment in which IFAD operates. Among these, the most significant is the risk posed by financial crises, which cause additional and increasing market uncertainties. IFAD effectively mitigated the impact of the recent financial crisis thanks to its prudent financial approach and investment and liquidity policies, and it remains fully vigilant. Weekly/daily meetings are held to review market movements and assess the need for any immediate actions to prevent the impact of possible losses in IFAD’s investment portfolio. Furthermore, Management has since the last review adopted the following measures, which directly or indirectly contribute further to mitigating the risks of overcommitment:

- Approval in December 2006 of the Liquidity Policy;
- Approval in 2008 of the IFAD Policy on Enterprise Risk Management (ERM), followed by the establishment in 2009 of an ERM framework and an ERM committee to spearhead policy implementation and an annual report.
- During 2009, as part of the broader ERM initiative, a self-assessment of internal controls over financial reporting was conducted in 2009 and a report was issued and presented at the Audit Committee in April 2010. This is a step towards moving to a full independent attestation of the adequacy of internal controls over financial reporting on the financial year 2012.

B. Risks and mitigation strategies

10. The following sections relate to mitigation strategies for risks linked to the objective of the Reserve.

Overcommitment of resources as a result of exchange rate fluctuations

11. This risk is mitigated by the general alignment of assets with the basket of currencies making up the special drawing rights (SDR). The Fund’s assets are maintained in such a way as to ensure that, to the extent possible, commitments for undisbursed loans and grants denominated in SDRs are matched by assets denominated in the currencies and ratios of the SDR currency basket. Similarly, the General Reserve and commitments for grants denominated in United States dollars are matched by assets denominated in that currency.

12. IFAD is currently undertaking a feasibility study on the possibility of lending in a single currency. A switch to single-currency lending would change IFAD’s currency exposure and its needs in terms of currency alignment procedures.

Overcommitment of resources as a result of delinquencies in the receipt of loan service payments

13. This risk is mitigated by the following:

- The possibility of delinquencies of loan service payments is continually assessed and an impairment provision is set up for any uncertainty about the receipt of loan principal repayments according to the original repayment schedule. As at 31 December 2009, this allowance amounted to some US$147.2 million in nominal terms.
- Loans with amounts overdue more than 180 days are placed in non-accrual status and the associated interest and service charges are recognized as income only when the cash is received. This, in effect, amounts to making provision for non-receipt of interest and service charges, and reduces future committable resources.
- An accounting provision is also made when a principal instalment is due for more than 24 months; and if the instalment is due for more than 48 months, the entire loan outstanding is provided for.

14. The above measures ensure that IFAD's loan balances are not overstated and present a true and fair picture in the financial statements. The amounts provided for are not available for commitment. IFAD undertakes additional measures to reduce the risk of accumulating arrears balances such as:

- For all loans that are 75 days in arrears, further disbursements are discontinued.
- Above 150 days, the entire portfolio is suspended.

15. IFAD's attention to sovereign risks remains high, even if its arrears situation has improved despite the financial crisis.

Overcommitment of resources as a result of delinquencies in the recovery of amounts due to the Fund from the investment of its liquid assets

16. The current investment policy has set the credit floor at AA- (Standard & Poor's) or Aa3 (Moody's) for fixed-interest investments, thus minimizing the risk of possible non-recovery of amounts due to the Fund for these investments.

17. IFAD requires that its external investment managers and custodian bank use due diligence in selecting counterparties for investment transactions, and that futures and options only be traded on regulated exchanges. For time deposits and certificates of deposit, IFAD uses counterparties with a credit rating of not less than A1 (Standard & Poor's) or P1 (Moody's).

Overcommitment as a result of significant diminution in the value of assets caused by fluctuations in the market value of investments.

18. This risk is closely linked to IFAD's investment policy. Since 2005 the Fund has not invested in equities. Furthermore, an agreed portion of the investment portfolio is now in held-to-maturity (HTM) assets, which shields it from market fluctuations. This enables IFAD to reduce the volatility of a portion of its portfolio thus giving some predictability of the performance of HTM securities.

19. IFAD uses value-at-risk (VaR) in order to estimate the maximum amount that the portfolio could lose in value over a defined time horizon with a 95 per cent confidence level. At 31 December 2009, the VaR of the investment portfolio for a three-month time horizon was 1.23 per cent of the total portfolio amount, equivalent to US$32.1 million.

20. The 2006 liquidity policy was adopted to strengthen IFAD's ability to meet disbursement needs. This policy is currently under review, and the General Reserve level should be re-evaluated once the policy is formalized.

21. As noted above, during and subsequent to the financial crisis, Management addressed effectively the most significant IFAD exposure to diminution in value – the securities lending activity – by downsizing considerably the volume of security lending, by setting up a separate IFAD securities lending portfolio so that it could be managed and monitored better, and by introducing more prudent investment guidelines. From the second quarter of 2010, IFAD has been reviewing its investment policy (including the possibility of exiting from the security lending programme by end-2010).

III. Comparison with other international financial institutions

22. Other international financial institutions (IFIs) have a different funding structure as they borrow from the market and consider reserves as a capital component to mitigate mismatches between assets and their funding liabilities (term risk). In view of the above fundamental difference, the Financial Services Division did not perform a detailed comparison as it would not have been meaningful. Some information on the capital structure of other IFIs is reported below:

- The retained earnings of the World Bank Group include earnings from current and prior years and specific reserves set up to cover liabilities incurred in the event of defaults on loans made, in addition to other reserves and surpluses.
- The retained earnings of the Asian Development Bank include various reserves, accounts and surpluses, such as a loan loss reserve, special reserve and ordinary reserve.
- The retained earnings of the Inter-American Development Bank include both a special reserve established for covering the liabilities incurred in the event of defaults on loans made and a general reserve, consisting of income from prior years.

IV. Accounting classification

23. The International Accounting Standards Board's framework for the preparation and presentation of financial statements sets out the concepts underlying financial statements prepared in conformity with International Accounting Standards and defines the various elements from which financial statements are constructed. In this context, equity is defined as "funds contributed by shareholders, retained earnings, reserves representing appropriations of retained earnings and reserves representing capital maintenance adjustments".

24. As the General Reserve constitutes an appropriation of prior-year income (transferred from the accumulated surplus), IFAD includes it as a component of capital and reserves. Therefore, for accounting purposes, the General Reserve has been separately disclosed on the face of the balance sheet as part of IFAD's capital and reserves since 2006. International Financial Reporting Standards requirements have not changed in this respect since.

V. Comments from the external auditor

25. As regards the classification of the General Reserve within IFAD's capital and reserves, PricewaterhouseCoopers considers this appropriate and in line with the relative documentation provided by Management in support of such a classification. This documentation consists of internal position papers and formal decisions by the Governing Council, confirming the original basis for setting up the General Reserve in 1980 and the amounts allocated to the General Reserve over the period 1980 to 1993. PricewaterhouseCoopers is not in a position to comment on the amount of the General Reserve, this clearly being solely a managerial decision.

VI. Conclusions and recommendation

26. Since the last assessment of the adequacy of the General Reserve by the Audit Committee in December 2006, additional risks have emerged, and IFAD Management has undertaken mitigating measures and introduced new risk management mechanisms.

27. Taking into consideration the mitigation measures currently in place, the Financial Services Division believes that Management, through operational, financial and accounting methods, is effectively dealing with the risk of potential overcommitment of resources as a result of:

- Exchange rate fluctuations;
- Possible delinquencies in the receipt of loan service payments;
- Possible delinquencies in the recovery of amounts due to the Fund from the investment of its liquid assets; and
- Possible diminution in value of assets caused by fluctuations in the market value of investments.

Overall, there is no reason to believe that the unmitigated risk of overcommitment has increased, so the General Reserve level at US$95 million is deemed adequate.

28. Given the volatility of the financial environment and associated risks, and given also the possibility of IFAD's venturing into new initiatives (instruments, funding modalities), there is a need to remain vigilant. Consequently it is recommended that the Committee, taking into account the implementation of new investment and liquidity policies, re-evaluate the adequacy of the General Reserve in early 2012 after the conclusion of the Consultation on the Ninth Replenishment of IFAD's Resources to capture comprehensively the impact of the new or emerging risks and mitigation elements to be introduced through these processes.