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IFAD

Enabling poor rural people
to overcome poverty

Review of the adequacy of the level of the General Reserve

Note to Executive Board representatives

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For: **Approval**

Recommendation

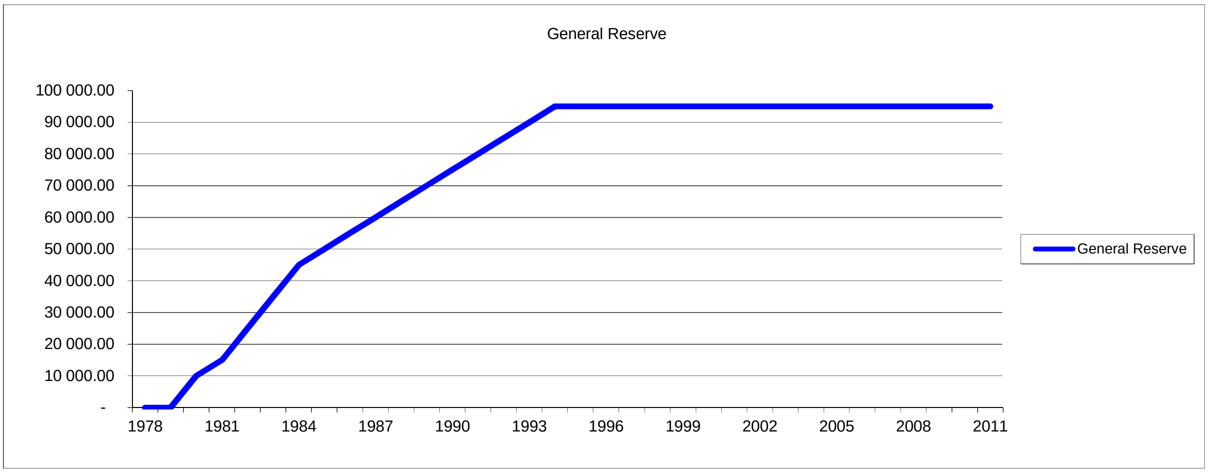
The Executive Board is invited to approve the recommendation that the General Reserve should remain at its current level of US$95 million, as contained in paragraph 40.

Review of the adequacy of the level of the General Reserve

I. Background

1. The General Reserve was established by the Governing Council in 1980[1] to address the potential risk of over-commitment 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 over-commitment risk resulting from a diminution in the value of assets caused by fluctuations in the market value of investments.
3. In establishing the General Reserve, the Governing Council authorized the Executive Board to approve future transfers from IFAD's resources up to a ceiling of US$100 million, taking into account the Fund's financial position. In 1999, the Governing Council decided 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. Figure 1 below shows a graphical presentation of the level of the General Reserve over time, from its establishment until the present date.

Figure 1
(In thousands of United States dollars)



4. The Executive Board[3] is required to review the level of the Reserve at least once every three years and the Audit Committee is required, by its Terms of Reference, to review the adequacy of the General Reserve and to report to the Executive

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[1] Governing Council resolution 16/IV.
[2] GC 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 2009/97/R.50/Rev.1).

Board with its conclusions and recommendations. The last review was conducted in December 2010. The current review is being undertaken in accordance with what was agreed in 2010, namely that the level of General Reserve was found adequate at that time but that another review would be conducted in two years' time to validate the conclusions and assess the applicability of the underlying assumptions.

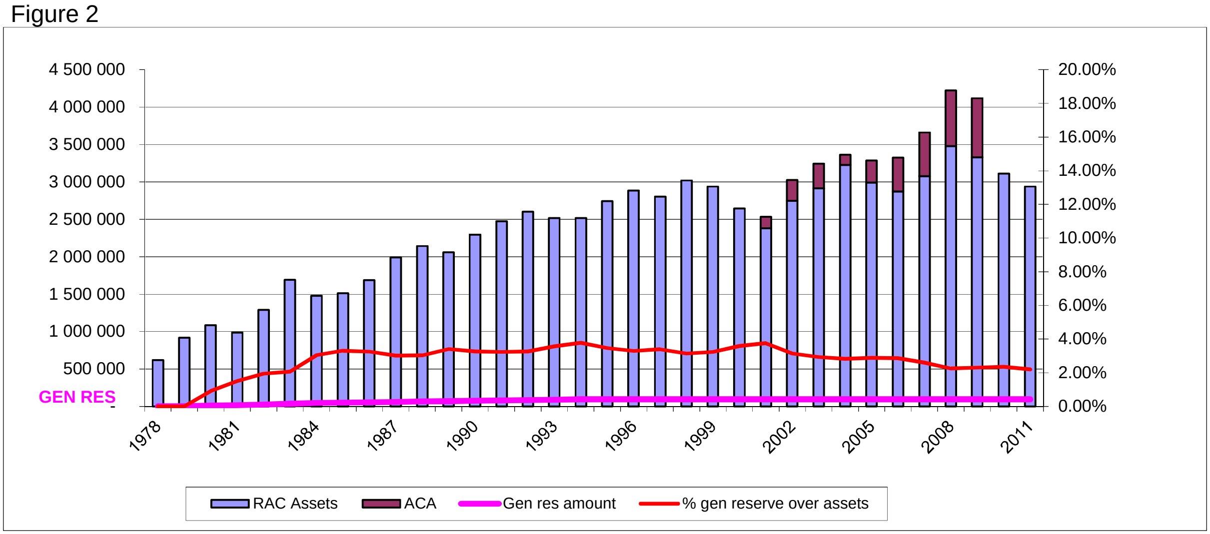
A. The risk of over-commitment of IFAD resources

5. 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. 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.

6. IFAD has always been mindful of over-commitment. This is evident in its definition of resources available for commitment, as set out in article 4 of the Agreement Establishing IFAD. Resources available for commitment comprise assets in freely convertible currencies net of IFAD's commitments for loans and grants. This restricted definition excludes, for instance, balance sheet assets such as instruments of contributions or receivables for disbursed loans (except to the extent allowed by the advance commitment authority [ACA] – see below), thus imposing a more prudent limit on what can be committed as loans and grants at any given time. Cognizant of the fact that this approach may have led to an underutilization of the financial resources of the Fund, IFAD's Governing Council authorized the use of ACA to allow for a portion of projected loan reflows to be considered as resources available for commitment. The Executive Board approves total resource commitment to be made through ACA at each of its sessions.

7. Figure 2 below provides historical trend information about the resources available for commitment over the years, relative to the levels of the General Reserve. The General Reserve balance was approximately 2.7 per cent of total resources available for commitment on average (2.2 per cent at the end of 2011) and approximately 3.6 per cent of the balance of loan and grant commitments (2.5 per cent at the end of 2011).

Figure 2



Note: RAC: resources available for commitment.

8. The slightly declining percentage of the Reserve as compared with the total committed resources reflects the introduction of risk mitigation measures and mechanisms over the years that have lowered the risk of over-commitment of resources and to some extent limited the scope of the General Reserve, as some of the risks are now addressed through other means. As a result, there has been no need to increase the General Reserve level.

9. Since the establishment of the General Reserve in 1980, International Accounting Standards (now subsumed into International Financial Reporting Standards) have evolved and more rigorous reporting requirements have been introduced. It is now a requirement to set up accounting provisions to cover specific risks (e.g. IFAD in recent years has introduced provisions for after-service medical coverage and loans in arrears) and that an equivalent amount of resources be earmarked (set aside) and not committed. The General Reserve amount, as well as the accounting provisions, is deducted from the resources available for commitment thus setting aside funds to meet any unmitigated risks of over-commitment. IFAD has further implemented specific risk mitigation strategies for each category of assets backing up commitments. These strategies include:

   - Creation of a separate Financial Planning and Risk Analysis Unit (FRA) to centralize the risk management of IFAD's resources, which reports directly to the Chief Financial Officer;
   - Detailed assessment of the financial health and resource situation of IFAD after each Replenishment Consultation;
   - Approval of the Liquidity Policy in December 2006;
   - Approval of the IFAD Policy on Enterprise Risk Management (ERM) in 2008, followed by the establishment of an ERM framework and an ERM committee in 2009 to spearhead policy implementation and prepare an annual report.
   - Approval of the new Investment Policy in 2011 (in the form of documents EB 2011/104/R.43 and R.44)

10. On the other hand, new risks have emerged in the environment in which IFAD operates since the Committee last reviewed the adequacy of the Reserve. 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 through a prudent and conservative approach in its investment and liquidity policies, and it remains fully vigilant. The Audit Committee and the Executive Board were apprised of actions and decisions taken to mitigate risks. Furthermore, since the last review, Management has adopted the following measures, which directly or indirectly contribute further to mitigating the risks of over-commitment:

   - The IFAD consolidated financial statements for 2011 introduced the first Management assertion report on the effectiveness of internal controls over financial reporting. The assertion report was issued with the audited financial statements. This is a step towards a full independent external attestation of the adequacy of internal controls over financial reporting, which is expected to be issued by the new external auditor on the 2012 financial statements.
   - During the Consultation on the Ninth Replenishment of IFAD's Resources in 2011, scenarios were reviewed focusing not only on the resources available for commitment but also on the long-term cash flow situation. In an effort to preserve the long-term financial health of the Fund, projections of IFAD's commitment capacity must first and foremost be deemed sustainable in terms of cash flows. That is, first, for all the programme of loan and grant (POLG) scenarios, IFAD's liquidity (i.e. the balance of its

cash and investments) should not breach the minimum liquidity requirement stipulated in the Liquidity Policy over the next 40 years and, second, the donor contribution requirement for a given POLG scenario should be sustainable in future replenishments. To this end, measures will be adopted to strengthen IFAD's financial model in line with models used by other international financial institutions (IFIs).

B. Types of risks leading to potential over-commitment and mitigation strategies in place

11. The following sections relate to mitigation strategies for the specific risks identified by the Governing Council in establishing the Reserve. In all risk analyses conducted for individual specific risks, it is assumed that the risk to be addressed is the inability to meet disbursement obligations for loans and grants approved to date as they fall due because of inadequate resources and, therefore, inability to further commit the Fund's disbursement capacity, taking 31 December 2011 as the assessment date (as audited financial information is available for that date).

Over-commitment of resources as a result of exchange rate fluctuations

12. 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 SDR (the bulk of the loan and grant portfolio) are matched by assets denominated in the currencies and ratios of the SDR currency basket. Similarly, commitments for grants denominated in United States dollars are matched by assets denominated in that currency. Table 1 provides historical trends in exchange rate variations between the United States dollar and SDR, as these variations directly affect the resources available for commitment.

Table 1

	31 Dec US$/SDR exchange	*Exchange rate yearly variation (percentage)*	*Exchange rate impact on committed resources (US$ million)*	*Exchange rate impact on committed resources (percentage)*
2001	1.257	-3.50%	(7.80)	-0.35%
2002	1.360	8.20%	(12.10)	-0.50%
2003	1.486	9.30%	1.60	0.06%
2004	1.550	4.30%	1.70	0.06%
2005	1.426	-8.00%	24.20	0.87%
2006	1.504	5.40%	(36.50)	-1.23%
2007	1.576	4.80%	(28.70)	-0.89%
2008	1.535	-2.60%	16.80	0.52%
2009	1.564	1.90%	(18.50)	-0.53%
2010	1.550	-0.87%	34.30	0.95%
2011	1.539	-0.74%	(4.10)	-0.11%

13. The last column provides evidence as to how the currency-matching policy shields the value of resources from exchange rate fluctuations. For every year of this past decade bar one, the impact on resources was contained to less than 1 per cent of the total value of commitments, well below the corresponding percentage change in the US$/SDR exchange rate.

14. The cumulative loss over the last 11 years (the average remaining disbursement period for commitments as at 31 December 2011) was US$29.1 million. Given the various factors affecting this risk and the assumption that currency misalignment will always be actively addressed by the Fund, this figure is assumed to represent an indication of potential loss in value of IFAD resources due to exchange fluctuations over the average period required to disburse effective loans (average 11 years).

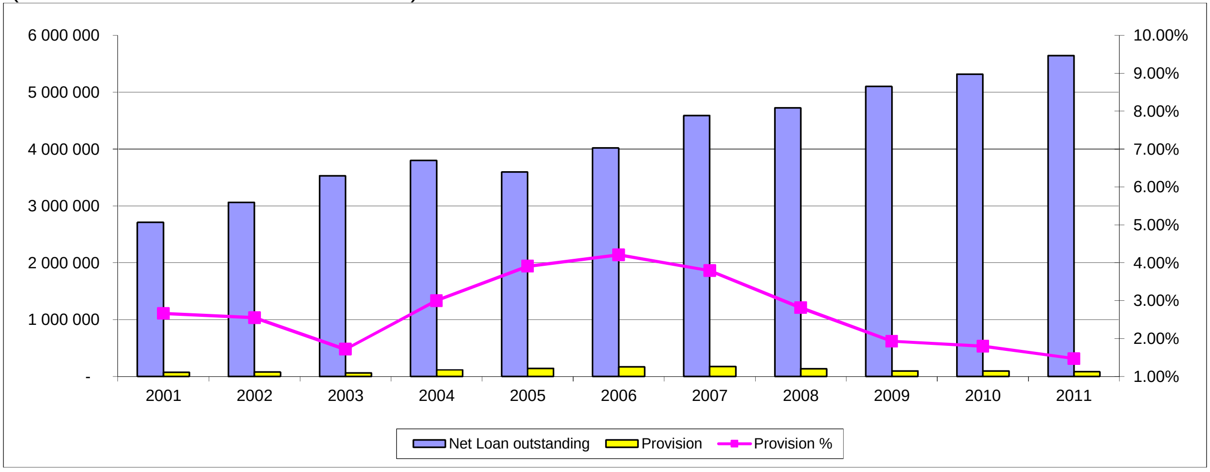
Over-commitment of resources as a result of delinquencies in the receipt of loan service payments

15. This risk impacts resources available for commitment to the extent allowed by the ACA. The main mitigation mechanism for this risk is the creation of accounting provisions linked to arrears that reduce the resources available for commitment, thereby ensuring that any doubtful receivables are not used to back up loan or grant approvals in the form of ACA.

16. An accounting provision is made when a principal instalment is due for more than 24 months for the amount of the overdue instalment; if the instalment is due for more than 48 months, the entire loan outstanding is provided for. As at 31 December 2011, this allowance amounted to some US$83.1 million in nominal terms, equivalent to 1.5 per cent of the balance of loans outstanding (US$5,644.7 million), well below the historical average of 2.7 percent and also below the three-year average of 1.7 per cent. The possibility of delinquencies of loan service payments is continually assessed and an impairment provision is set up in the accounts for any uncertainty on the receipt of loan principal repayments according to the original repayment schedule.

17. Figure 3 below shows historical trends for loans in arrears, comparing the provisions for arrears (made on the basis of the above criteria) with the total value of outstanding loans.

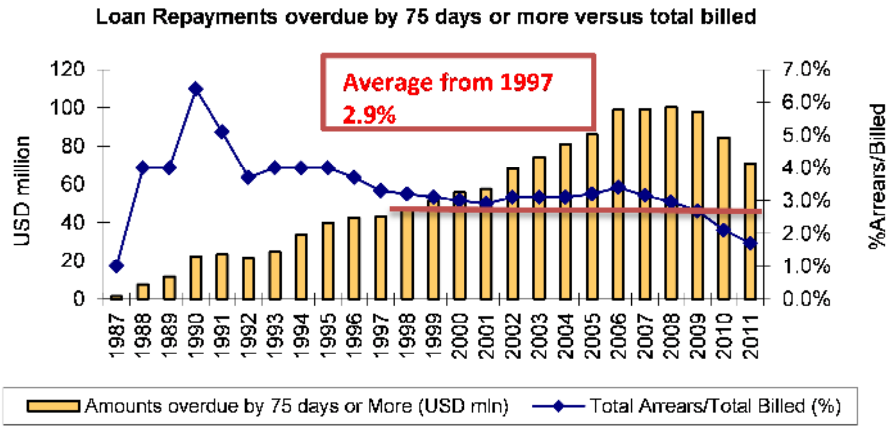
Figure 3
(In thousands of United States dollars)



18. The trend has been very positive since 2006, aided to some extent by the Debt Initiative for Heavily Indebted Poor Countries, and the current level is well below the highest level of more than 4 per cent reached in 2006.

19. Further to the accounting provisions, IFAD undertakes operational measures to reduce the risk of accumulating arrears balances, such as discontinuing disbursements of loans that are 75 days in arrears, or suspending the entire portfolio for arrears lasting more than 150 days. Figure 4 below presents the percentage of amounts in arrears for more than 75 days in comparison with the overall amounts billed.

Figure 4



20. At the end of December 2011, the amount related to overdue instalments was US$71.1 million, representing 1.7 per cent of amounts billed, which is below the historical average of 2.9 per cent. It should be emphasized that this amount relates almost exclusively to loans approved prior to 1995. Arrears for loans approved after 1995 amount to 0.16 per cent of the overall amount billed, despite the several economic crises that have affected many IFAD borrowers in the last ten years.

21. The arrears risk is provided for and controlled effectively by the Fund and it has a minimal effect on the stability of the loan reflows. IFAD's attention to sovereign risks remains high. The risk of arrears and default is already covered adequately by the provisions in place and the improving arrears experience limits the need for any additional provision (as part of the General Reserve).

22. In the unlikely scenario that the incidence of overdue instalments of amounts billed were to return to the three-year historical average level of 1.7 per cent (from 1.5 per cent), then a 26 per cent increase in provisions might also be warranted (i.e. approximately US$21.5 million, within the General Reserve).

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

23. 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 on these investments.

24. 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). Table 2 provides some historical information about IFAD holdings and credit ratings.

Table 2

Portfolio	*Average Moody's credit rating*[a]				
	2011	*2010*	*2009*	*2008*	*2007*
Short-term liquidity	P1	P1	P1	P1	P1
Government bonds	Aa1	Aaa	Aaa	Aaa	Aaa
Diversified fixed-interest	Aa1	Aa1	Aa1	Aaa	Aaa
Inflation-linked	Aaa	Aaa	Aaa	Aaa	Aaa
Held to maturity (HTM)	Aa1	Aaa	Aaa	Aaa	Aaa

[a] The average credit rating is calculated based on market values as at 31 December in the year specified except for the HTM portfolio which is calculated on face values.

Over-commitment as a result of significant diminution in the value of assets caused by fluctuations in the market value of investments

25. This risk is closely linked to IFAD's Investment Policy. Mitigation measures adopted since 2005 include a complete exit from investing in equities, designating part of the investment portfolio as held-to-maturity (HTM) assets and adopting a liquidity policy that set a minimum liquidity level for the portfolio. These measures have enabled IFAD to reduce the overall volatility of investment returns and manage effectively the market shocks linked to the financial crisis. As a consequence of the crisis, some securities have been downgraded below the IFAD required rating. Management has adopted a cautious divestment strategy in collaboration with external portfolio managers to deal with these particular cases. Furthermore, during and subsequent to the financial crisis, Management addressed effectively the most significant exposure to diminution in value – the securities lending activity. This was achieved by immediately downsizing considerably the volume of security lending in 2009 in preparation for a full exit by end-2010 and by introducing more prudent investment guidelines.

26. IFAD uses value-at-risk (VaR) to estimate the maximum amount that the portfolio could lose in value over a defined time horizon with a 95 per cent confidence level. This is a risk measure that takes into consideration all factors that can result in a diminution in the market value of the marked-to-market portfolio. Therefore the VaR provides a good basis for the purposes of assessing the adequacy of the General Reserve.

27. At 31 December 2011, the VaR of the investment portfolio for a three-month time horizon was estimated at 1.33 per cent of the total portfolio amount, equivalent to US$32.9 million, i.e. there was a 5 per cent chance that the IFAD portfolio would lose more than US$32.9 million in the ensuing three months.

28. As apparent from table 3 below, IFAD's actual portfolio VaR is lower than the investment policy/benchmark VaR, which is a sign of additional prudence.

Table 3

	Portfolio		Policy	
Date as at 31 Dec	*Portfolio VaR (percentage)*	*Amount (thousands of US$)*	*Benchmark VaR (percentage)*	*Amount (thousands of US$)*
2002	1.8	38 100	2.4	50 300
2003	1.7	39 600	2.0	45 300
2004	1.5	37 000	1.7	41 800
2005	1.2	27 470	1.4	33 950
2006	0.8	18 000	1.4	32 300
2007	1.3	32 500	1.4	35 000
2008	1.5	33 245	1.3	39 533
2009	1.2	32 080	1.3	33 987
2010	1.1	27 986	1.2	29 946
2011	1.3	32 871	1.3	31 490

Note: Until 2005, IFAD was still investing in equities, while the change from 0.8 to 1.3 per cent (2006-2007) was a result of the short-term tactical liquidation of US$413,501,000 equivalent.

29. As part of the implementation of the new Investment Policy, IFAD is in the process of adopting conditional value-at-risk (CVaR) as an additional risk measure. Created as an extension of VaR, conditional value at risk is not based on the assumption of normally distributed returns, and it quantifies the average expected losses in the left "tail-end" of the distribution beyond the VaR. The CVaR is more appropriate for estimating the losses in case of extreme events; this measure could be considered in future reviews of General Reserve adequacy.

C. Comparison with other international financial institutions

30. In general, other IFIs have a different funding structure: they borrow from the market and consider reserves as a capital component to mitigate mismatches between assets and their funding liabilities (term risk). The concessional lending arms of the IFIs – which are closer to IFAD in terms of activity – do not in general have specific reserves similar to IFAD's General Reserve in their balance sheets, as they are assured of support from the "parent" group in case of resource shortages.

31. In view of the above fundamental differences, a detailed comparison was not performed 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.

D. Summary of risks and mitigation strategies

32. As reported above, IFAD adopted a very prudent definition of resources available for commitment that already ensures that the level of commitments remains well below the level of net assets of the Fund. IFAD has also adopted specific mitigation strategies for each financial risk (currency exposure risk, credit and market risk, and liquidity risk) and consequently on each item of IFAD's resources available for commitment. In addition, IFAD established the General Reserve to address the potential risk of over-commitment of resources as a result of unmitigated risks, arising from unforeseen circumstances.

33. The indicative potential extent of loss linked to the various risks underlying the over-commitment risk as assessed above are:

    - US$29.1 million: Exchange rate fluctuations may create misalignment between the value of committed resources and the corresponding loan and grant commitments (currency risk). (Currency loss during last seven years due to appreciation/depreciation of the United States dollar against special drawing rights.)
    - US$32.9 million: Diminution in the value of assets caused by fluctuations in the market value of investments (market risk) and delinquencies in the recovery of amounts due to the Fund from the investment of its liquid assets (credit risk). (VaR of the investment portfolio for a three-month time horizon at 5 per cent.)
    - US$21.5 million: Delinquencies in the receipt of loan service payments (credit risk). (Roughly reflects the increase in provisions caused by a 26 per cent increase in incidence of overdue payments.)

34. The total quantified potential loss in the above risk categories can be estimated at US$83.5 million. This quantitative analysis can only serve to give a general measure of the impact of potential risks. The figures are indicative and subject to several assumptions. Furthermore, the Fund can potentially call on non-committed assets, even though of a much longer-term nature, to meet potential shortfalls.

II. Accounting (disclosure requirement) and the external auditor's views

35. 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".

36. 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 remain unchanged as of this date.

37. As regards the classification of the General Reserve within IFAD's capital and reserves as at 31 December 2011, IFAD's external auditor considered 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. External auditors are not in a

position to comment on the adequacy or appropriateness of the amount or level of the General Reserve, this clearly being solely a managerial decision.

III. Conclusions and recommendation

38. Since the last assessment of the adequacy of the General Reserve by the Audit Committee in December 2010, additional risks have emerged, and IFAD Management has undertaken mitigating measures and introduced new risk management mechanisms.

39. Taking into consideration the mitigation measures currently in place, Management believes that through operational, financial and accounting methods it is effectively dealing with the risk of potential over-commitment 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.

40. In view of the analysis above, and considering the mitigating measures being implemented (as elaborated in the sections above) to ensure minimum risk exposure, Management believes that the residual risk of possible over-commitment has not increased since the last review. It is Management’s considered opinion that the General Reserve at US$95 million is set at a prudent and appropriate level, having considered:

- The strengthened mitigation tools and strategies introduced by the Fund, especially in recent years, to address the risk of over-commitment of resources and IFAD’s strong record as regards investment performance and loan arrears management in recent years;
- The increased risks linked to the greater volatility of financial and credit markets and growth in the volume of activities and consequently commitments; and
- The indications provided by the quantitative analysis of the potential level of loss linked to the assessed risks and the need to maintain a prudent margin.

41. Notwithstanding the above conclusion, the General Reserve level should be re-evaluated during the Ninth Replenishment period (2013-2015) in light of key deliverables under the Ninth Replenishment Consultation:

- Deployment of an enhanced financial model based on a sustainable cash flow approach. Management should consider presenting a proposal to the Executive Board regarding the future use of the ACA, once the sustainable cash flow approach has been fully implemented.
- A proposal for compensation for foregone principal arising from adoption of the Debt Sustainability Framework , starting in IFAD10, will be realized as agreed at the commencement of the DSF in 2007.