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Investing in rural people

Review of the adequacy of the level of the General Reserve

Note to Executive Board representatives

Focal points:

Technical questions:

Michel Mordasini
Vice-President
Interim Head
Financial Operations Department
Tel.: +39 06 5459 2518
e-mail: m.mordasini@ifad.org

Ruth Farrant
Director and Controller
Controller's and Financial Services Division
Tel.: +39 06 5459 2281
e-mail: r.farrant@ifad.org

Allegra Saitto
Manager
Accounting and Financial Reporting
Tel.: +39 06 5459 2405
e-mail: a.saitto@ifad.org

Dispatch of documentation:

Alessandra Zusi Bergés
Officer-in-Charge
Governing Bodies Office
Tel: +39 06 5459 2092
e-mail: gb_office@ifad.org

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Review of the adequacy of the level of the General Reserve

I. Background

1. The General Reserve was established by the Governing Council in 1980¹ to address 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 Council² 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. 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.
4. The Executive Board is required by the Governing Council to review the level of the Reserve periodically³ and the Audit Committee⁴ is required, by its Terms of Reference, to review the adequacy of the General Reserve and to report to the Executive Board with its conclusions and recommendations. The last review was conducted in December 2012.
5. IFAD has always been mindful of overcommitment and, since the last review, Management has adopted additional measures that, directly or indirectly, contribute further to mitigating the risks of overcommitment as follows:
 - In 2012, IFAD's consolidated financial statements were externally audited for the first time not only on the accuracy of the accounts but also on the effectiveness of internal controls over financial reporting.
 - During 2014, the accounting policy regarding provisioning was strengthened to assess, further, the creditworthiness of all outstanding financial assets.
 - Since the Consultation on the Ninth Replenishment of IFAD's Resources (IFAD9) in 2011, financial scenarios and the amount of resources available for commitment have focused on IFAD's long-term cash flow sustainability. In order 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. This means that 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 that the donor contribution requirement for a given programme of loans and grants scenario should be sustainable in future replenishments. The Agreement Establishing IFAD states, in article 7, section 2(b): "The proportion of the Fund's resources to be committed in any financial year ... shall be decided from time to time by

¹ Governing Council resolution 16/IV.

² GC 22/L.9.

³ Regulation XIII(b), Financial Regulations of IFAD, as amended by the Governing Council at its thirty-fifth session.

⁴ 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).

the Executive Board with due regard to the long-term viability of the Fund and the need for continuity in its operations.”

- The compensation mechanism for forgone principal arising from the adoption of the Debt Sustainability Framework was approved with the adoption of the resolution on IFAD10 by the Governing Council at its thirty-eighth session in February 2015.
6. Since 2012, additional financial events have occurred:
- In November 2014, IFAD signed its first borrowing framework agreement for an overall amount of EUR 400 million and within this framework the first Individual Loan Agreement was signed for an amount of EUR 100 million.
 - The IFAD10 resolution (186/XXXVIII) was adopted by the Governing Council in February 2015. However, the replenishment target and effectiveness are still pending as at the date of this report.
 - In April 2015, at its 114th session, the Executive Board approved the Sovereign Borrowing Framework (2015/114/R.17/Rev.1) with the purpose of defining parameters for borrowing from Member States and state-supported institutions. This framework will be subject to a review during 2016.
7. A greater emphasis is now placed on cash flow and liquidity levels. Consequently, the level of the General Reserve and the risks of overcommitment should be reviewed in light of resource definition based on sustainable cash flows and considering all factors that will impact IFAD’s liquidity. Management is proposing to postpone the formal assessment of the level of the General Reserve to 2016. This will enable the Fund to embed in such assessment the outcomes of the forthcoming review on the Sovereign Borrowing Framework, as well as to factor in the level of contributions to IFAD10. Furthermore, a new accounting principle will become mandatory in 2018 (International Financial Reporting Standard [IFRS] 9), prescribing a more stringent impairment policy on financial assets, which may be relevant in the assessment. According to IFRS 9, the collectability of financial assets should be subject to impairment tests, considering the historical data as well as full lifetime expected credit losses. The postponement of the General Reserve review will also allow Management to conduct a preliminary review of the implications of this new accounting principle and to anticipate, if possible, the impact thereof.

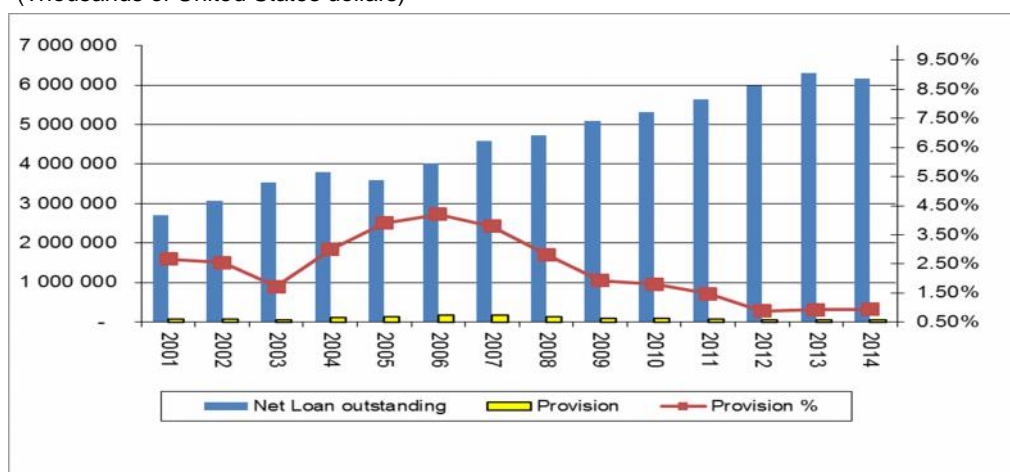
II. Financial risks

8. While Management is proposing to postpone the formal review of the General Reserve, it remains extremely vigilant over financial risks ensuring adequate mitigation strategies. In this context, the following sections provide a summary of the relevant measures in place as at 31 December 2014.
9. The risk generated by exchange rate fluctuations 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 (mainly denominated in SDR) are fully covered by assets denominated in the four components of the SDR basket and by future loan reflows that are already denominated in SDR. Similarly, commitments for grants denominated in United States dollars and loans denominated in euro are matched by assets denominated in that currency. It should be noted that even if currency risks are fully mitigated through hedging of related assets, significant foreign exchange movements have implications for IFAD accounts. The majority of IFAD’s assets are denominated in SDR, while the reporting currency is the United States dollar. Foreign exchange movements can have a positive or negative impact on IFAD’s assets, as these assets are translated into United States dollars for reporting purposes. Any

material fluctuations in the US\$/SDR foreign exchange rate create volatility in IFAD's accounts, with periodically positive and negative movements depending on the exchange rate fluctuation; however, these have historically netted out.

10. The foreign exchange movements are unrealized paper gains/losses on IFAD's profit and loss statement but they do not have repercussions on IFAD's financial stability, as at any point in time IFAD ensures that there is enough liquidity to meet disbursement requirements.
11. The possibility of delinquencies in loan service payments is assessed on a weekly basis. 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.⁵ As at 31 December 2014, this allowance amounted to some US\$58.1 million in nominal terms, equivalent to 0.9 per cent of the balance of loans outstanding (US\$6,174 million), well below the historical average of 2.4 per cent.
12. Figure 1 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.

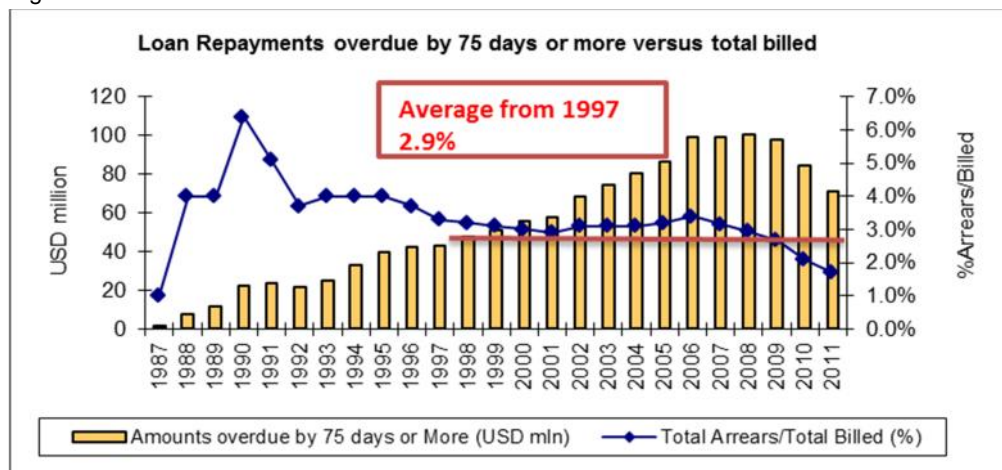
Figure 1
(Thousands of United States dollars)



13. 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 and suspending the entire portfolio. Figure 2 below presents the percentage of amounts in arrears for more than 75 days in comparison with the overall amounts billed.

⁵ See 2014 IFAD Consolidated Financial Statements: An allowance is established on a specific basis for such losses based on the difference between the assets' carrying value and the present value of estimated future cash flows discounted at the financial assets' original effective interest rate (i.e. the effective interest rate calculated at initial recognition). In cases where it is not possible to estimate with any reasonable certainty the expected cash flows of a loan (as in all cases for which an allowance has been established to date), an alternative approach is followed that adopts a method similar to the benchmark used for the provisioning of Member States' contributions. This means that an allowance shall be made on loan instalments overdue for more than 24 months. An allowance is also made for loan instalments on the same loan overdue for less than 24 months. Once this trigger period has been reached, all amounts overdue at that time are considered to be in provision status, even in the event that part of the total outstanding debt is subsequently repaid. In cases where more than 48 months have elapsed, an allowance is made for all outstanding principal amounts of the loan concerned. The point in time to determine whether the given period has elapsed is the balance sheet date. Considering the positive historical loan reflow trends for which losses have not been recorded so far, the Fund has not established a collective impairment provision on loans not subject to specific impairment. Income on loans is recognized following the accrual basis of accounting. For loans with overdue amounts in excess of 180 days, interest and service charges are recognized as income only when actually received. Follow-up action is being taken with the respective governments to obtain settlement of these obligations.

Figure 2



14. The risk associated with delinquencies in the recovery of amounts due to IFAD from the investment of its liquid assets is mainly managed by setting prudent credit ratings as defined in the IFAD Investment Policy. Table 1 below summarizes the credit rating floors as at 31 December 2014.

Table 1

Credit rating floors (as at 31 December 2014)

Eligible asset classes	Credit rating floors for Standard & Poor's, Moody's and Fitch ratings
Short-term investments	Counterparty must have a minimum short-term credit rating of A-1 (Standard & Poor's) or F1 (Fitch) or P-1 (Moody's)
Government and government agencies fixed-income securities	Investment grade
Government and government agencies inflation-linked fixed-income securities	Investment grade
Supranationals	Investment grade
Asset-backed securities (only agency issued or guaranteed)	AAA
Corporate bonds	Investment grade

Source: 2014 consolidated financial statements.

15. IFAD requires that its external investment managers and custodian bank exercise 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 A-1 (Standard & Poor's) or P-1 (Moody's).
16. The impact on IFAD's accounts caused by significant fluctuations in the market value of investments is closely linked to IFAD's Investment Policy. As a mitigation measure, part of the investment portfolio has been designated at amortized cost. Moreover, IFAD's liquidity policy sets a minimum liquidity level for the portfolio. These measures have enabled IFAD to reduce the overall volatility of investment returns, manage effectively the market shocks linked to the financial crisis and better ensure the delivery of IFAD's commitments.
17. Since 2012, IFAD has adopted conditional value-at-risk (CVaR) as an additional risk measure. Created as an extension of VaR, CVaR is not based on the assumption of normally distributed returns. The one-year CVaR at 95 per cent is a measure of the potential average expected loss of a portfolio which is increased under extreme conditions (the so-called "left tail"). It gives an indication of how much value a portfolio could lose, on average, over a forward looking one-year horizon with a 95 per cent confidence level. To derive this measure the portfolio is revalued (stressed) assuming a large number of market condition scenarios affecting its value. For example, a CVaR of 6 per cent on a portfolio of US\$1,000,000 means

there is a 95 per cent chance that the average loss of the portfolio will not exceed US\$60,000 in one year.

Table 2
CVaR of IFAD's current asset classes as at 31 December 2013 and 2014

	<i>Actual investment portfolio one-year CVaR</i>		<i>One-year CVaR IPS budget level</i>
	<i>31 December 2013</i>	<i>31 December 2014</i>	
Global government bonds	1.07	0.87	4.00
Global diversified fixed-income bonds	5.73	4.46	15.00
Global inflation-indexed bonds	6.87	5.74	9.00
Emerging market debt bonds	10.69	9.99	27.00
Total portfolio (including global strategic portfolio and operational cash)	2.76	2.56	6.00

Note: Confidence level at 95 per cent. Percentages based on historical simulations over five-year history.

18. The CVaRs of all single asset classes and that of the overall portfolio were below prescribed risk budget levels and lower than in the previous year.
19. It should be noted that IFAD investment policy is subject to yearly reviews to ensure that risk measures are properly calibrated to evolving market conditions.

III. Conclusions

20. Taking into consideration the mitigation measures currently in place, Management believes that through operational and financial methods, the following financial risks are being addressed effectively:
 - 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.
21. In view of further financial developments, such as:
 - Introduction and revision of the Sovereign Borrowing Framework;
 - Finalization of the IFAD10 level; and
 - New accounting requirements dictated by IFRS 9,

Management is proposing to postpone the formal review of the adequacy of the General Reserve to 2016 in order to assess, more fully, all financial implications.