Review of the adequacy of the level of the General Reserve

Note to Executive Board representatives

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For: Approval
Recommendation for approval

The Executive Board is invited to approve the following decisions:

In accordance with regulation XIII(b) of the Financial Regulations of IFAD, as amended by the Governing Council at its thirty-fifth session, the Executive Board agrees to maintain the General Reserve at the current level of US$95.0 million and reconsider this assessment in 2017.

Review of the adequacy of the level of the General Reserve

I. Executive summary

1. The General Reserve was established by the Governing Council in 1980\(^1\) to address the potential risk of overcommitment of IFAD’s 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
   - The potential overcommitment risks resulting from a diminution in the value of assets caused by fluctuations in the market value of investments.

2. Between 1980 and 1994 the Executive Board approved several transfers, bringing the General Reserve up to its current level of US$95.0 million. The General Reserve has never been used.

3. IFAD has always been mindful of financial risks. Consequently, Management has adopted several measures that, directly or indirectly, mitigate such risks. This has strengthened the financial framework in which IFAD operates, in line with evolving business practices.

4. The introduction of the long-term sustainable cash flow approach as a mechanism to define IFAD’s commitment capacity reduced the relevance of the General Reserve. Since the Ninth Replenishment of IFAD’s Resources (IFAD9), risks of overcommitment of IFAD’s resources have been mitigated by ensuring the availability of sufficient liquidity to meet overall disbursement needs.

5. Despite IFAD’s sound financial framework, it is recommended that the General Reserve be maintained at the current level of US$95.0 million and that this decision be reconsidered in one year’s time, when the assumptions and implications of International Financial Reporting Standard 9 (IFRS9) are more concrete. This would be a suitably prudent approach for IFAD in view of the scaling up of borrowing activities and a possible rating exercise.

II. Background

6. The General Reserve was established by the Governing Council in 1980 to address the potential risk of overcommitment of IFAD’s resources as a result of:
   - Exchange rate fluctuations;
   - Possible delinquencies in the receipt of loan service payments; and

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\(^1\) Governing Council resolution 16/IV.
• Possible delinquencies in the recovery of amounts due to the Fund from the investment of its liquid assets.

7. In 1999, the Governing Council\(^2\) recognized the need to provide further cover for the Fund against potential overcommitment risks resulting from a diminution in the value of assets, caused by fluctuations in the market value of investments.

8. 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$95.0 million.

9. From 1980 to 2013, IFAD’s resources available for commitment were defined under the advance commitment authority scheme. This approach was static, as it was based on a statement in which availability of funds was calculated by deducting from some of IFAD’s assets (liquidity and promissory note receivables) the level of commitment for undisbursed loans and grants and the General Reserve (refer to EB/2013/108/R.20 for details). Therefore the risk of overcommitment was assessed within the framework of the resources available for commitment as defined under the advance commitment authority scheme.

10. Since the IFAD9 Consultation in 2011, financial scenarios and the amount of resources available for commitment have focused on the sustainability of IFAD’s long-term cash flow. 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) that: “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”.

11. The Executive Board is required by the Governing Council to review the level of the General Reserve periodically,\(^3\) and the Audit Committee\(^4\) is required by its Terms of Reference to review the adequacy of the General Reserve and to report its conclusions and recommendations to the Executive Board. The last full review was conducted in December 2012.

12. In 2015 the Audit Committee was presented with a desk review of major financial risks and relevant mitigation strategies in place as at 31 December 2014. The Audit Committee noted the increased emphasis on cash flow and liquidity levels and the possible impact of the new accounting principle – IFRS 9 – which would become mandatory in 2018 and would require a more stringent impairment policy on financial assets. It was therefore agreed to postpone the full review of the level of the General Reserve to 2016.

13. This document provides an updated summary of relevant measures in place as at 31 December 2015 to mitigate financial risks. It also offers a preliminary assessment of the implementation of the new impairment accounting standard and provides some recommendations for Executive Board consideration.

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\(^2\) GC 22/L.9.

\(^3\) GC 35/L.7, Regulation XIII(b), Financial Regulations of IFAD, as amended by the Governing Council at its thirty-fifth session.

III. Financial risks

14. IFAD has long been mindful of the risks of overcommitment and Management has adopted several measures that, directly or indirectly, help mitigate this risk in line with IFAD’s evolving business practices, for example:

- Since 2012, IFAD’s consolidated financial statements have been audited externally for accuracy of the accounts and also to verify the effectiveness of internal controls over financial reporting.
- During 2014, the accounting policy regarding the provision of financial assets was strengthened to assess further the creditworthiness of all outstanding financial assets.
- The compensation mechanism for forgone principal arising from 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.
- 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, inclusive of a section on the financial risks associated with borrowing activities and mitigation strategies.

15. As already reported during last year’s desk review, Management believes that the risks of overcommitment are being addressed effectively through operational and financial methods, as follows:

- 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 to the extent possible that 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 bulk 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 creates volatility in IFAD’s accounts, with periodically positive and negative movements depending on the exchange rate fluctuation; however, these have historically netted out.

- The foreign exchange movements are unrealized paper gains/losses on IFAD’s profit-and-loss statement. They do not have repercussions for IFAD’s financial stability because IFAD ensures that there is enough liquidity to meet disbursement requirements at any point in time. To strengthen the possibility of proactively managing foreign exchange risks, IFAD is entering into an International Swaps and Derivatives Association (ISDA) agreement5 with major banks. These agreements will become operational in 2017.

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5 The ISDA Master Agreement is the most commonly used master service agreement for over-the-counter (OTC) derivatives transactions internationally. It is part of a framework of documents, designed to enable OTC derivatives to be documented fully and flexibly. The framework consists of a master agreement, a schedule, confirmations, definition booklets and a credit support annex. The ISDA master agreement is published by ISDA. The master agreement is a document agreed between two parties that sets out standard terms that apply to all the transactions entered into between those parties. Each
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 summarizes the credit rating floors as at 31 December 2015.

Table 1
Credit rating floors (as at 31 December 2015)

<table>
<thead>
<tr>
<th>Eligible asset classes</th>
<th>Credit rating floors for Standard &amp; Poor’s (S&amp;P), Moody’s and Fitch</th>
</tr>
</thead>
<tbody>
<tr>
<td>Money market</td>
<td>Counterparty must have a minimum short-term credit rating of A-1 (S&amp;P) or F1 (Fitch) or P-1 (Moody’s)</td>
</tr>
<tr>
<td>Fixed-income both nominal and inflation-linked</td>
<td>Investment grade</td>
</tr>
<tr>
<td>Government and government agencies fixed-income securities at national or subnational levels</td>
<td>Investment grade</td>
</tr>
<tr>
<td>Supranational</td>
<td>Investment grade</td>
</tr>
<tr>
<td>Asset-backed securities (only agency issued or guaranteed)</td>
<td>AAA</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>Investment grade</td>
</tr>
<tr>
<td>Developed market equity</td>
<td>Investment grade</td>
</tr>
<tr>
<td>Currency forwards</td>
<td>Counterparty must have a minimum short-term credit rating of A-1 (S&amp;P) or F1 (Fitch) or P-1 (Moody’s)</td>
</tr>
</tbody>
</table>


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 (S&P) or P-1 (Moody’s).

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.

Since 2012, IFAD has adopted conditional value-at-risk (CVaR) as an additional risk measure. As shown in table 2, the CVaR of all single asset classes and that of the overall portfolio were below prescribed risk budget levels and lower than in the previous year. It should be noted that IFAD’s Investment Policy is subject to yearly reviews to ensure that risk measures are properly calibrated to evolving market conditions.

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6 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 2015 and 2014

| Asset liability portfolio (excluding cash) | 6.68 | n.a. | 8.00 |
| Global government bonds | 0.75 | 0.87 | 4.00 |
| Global diversified fixed-income bonds | 4.93 | 4.46 | 15.00 |
| Global inflation-indexed bonds | 7.15 | 5.74 | 9.00 |
| Emerging market debt bonds | 7.89 | 9.99 | 27.00 |
| Total portfolio (including global strategic portfolio and operational cash) | 3.34 | 2.56 | 6.00 |

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

- The possibility of delinquencies in loan service payments is monitored 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. As at 31 December 2015, this allowance amounted to some US$35.5 million in nominal terms, equivalent to 0.57 per cent of the balance of loans outstanding (US$6,207 million), well below the historical average of 2.4 per cent.

- Figure 1 below shows historical trends for loans in arrears, comparing the provisions balance with the total value of outstanding loans.

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7 See 2015 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.
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.

16. IFAD’s solid financial position and proactive management of underlying financial risks are also visible from the main financial ratios:

- As explained earlier, since IFAD, a greater emphasis has been placed on cash flow and liquidity levels to preserve the long-term financial health of the Fund. Prudent liquidity risk management includes maintaining sufficient cash and cash equivalents to meet loan and grant disbursements as well as other administrative outflows as they arise. As at 31 December 2015, the liquidity position of the Fund was strong, with sufficient liquid assets to cover projected disbursement needs for more than two years.

- The long-term financial viability of the Fund is monitored closely through an asset liability model and is reviewed by IFAD Management regularly, as well as by IFAD’s Member States during replenishment consultations.

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9 IFAD liquidity US$1,513.7 million/net disbursement needs as per the minimum liquidity ratio of US$680 million = 2.2 years.
Term structure risks are the financial risks that usually result when the timing and/or financial maturity of cash flows (i.e. principal and interest) between assets and their funding liabilities do not match. Funding, refinancing and reinvestment risks are three of the most typical term structure risks.

IFAD has no significant exposure to term structure risks because it is mainly funded by equity (i.e. reserves and contributions), which, by definition, do not entail specific interest/principal payments.

Under the current financial mechanism (inclusive of borrowing), and despite negative retained earnings, IFAD’s net equity is positive and its financial situation is sound. At the end of December 2015, total equity (contributions plus General Reserve) over total assets was equivalent to 93.5 per cent in nominal terms.

As an additional indicator of risk, the Sovereign Borrowing Framework requires that the debt/equity ratio shall not be higher than 35 per cent. The ratio stands at 2.0 per cent as at the end of December 2015.

All financial risk parameters are well within the thresholds established by the Sovereign Borrowing Framework as adopted in April 2015. The financial ratios are summarized in table 3.

Table 3
Financial ratios as at December 2015

<table>
<thead>
<tr>
<th>Ratio</th>
<th>December 2015</th>
<th>Threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity/total assets</td>
<td>93.5%</td>
<td>&gt;60%*</td>
</tr>
<tr>
<td>Debt/equity</td>
<td>2.0%</td>
<td>&lt;35%</td>
</tr>
<tr>
<td>Liquidity</td>
<td>17.8%</td>
<td>&gt;5%</td>
</tr>
<tr>
<td>Liquidity/disbursement needs</td>
<td>2.2 years</td>
<td></td>
</tr>
<tr>
<td>Debt service coverage</td>
<td>0.1%</td>
<td>&lt;50%</td>
</tr>
</tbody>
</table>


IV. Comparison with other international financial institutions

In general, other international financial institutions (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 the case of resource shortages.

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.

10 The debt/equity ratio is (a) the ratio of (i) principal portion of total outstanding debt to (ii) total contributions plus General Reserve (expressed in percentage terms); (b) calculated as (total outstanding debt principal/contributions plus General Reserve).
• 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.

V. Accounting (disclosure requirement) and the external auditor’s views

19. 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 the IFRS 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”. Furthermore, reserves are considered a classification within retained earnings to serve as an additional measure of protection from the effects of losses, usually in compliance with statutory requirements.

20. As the General Reserve constitutes an appropriation of prior-year income (transferred from the accumulated surplus), 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. IFRS requirements remain unchanged as of this date.

21. As regards the classification of the General Reserve within IFAD’s capital and retained earnings, as at 31 December 2015, IFAD’s external auditors considered this appropriate and in line with the relative documentation provided by Management in support of such a classification. The 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.

VI. Possible impacts of new accounting and reporting standards

22. IFRS9 will be in effect for annual periods beginning after 1 January 2018. Following the financial crisis, timeliness in recognizing expected credit losses has become crucial. The IFRS9 impairment section has been designed to address this need.

23. The impairment methodology under International Accounting Standard (IAS) 39 is known as an incurred loss model; impairment is recognized when there is evidence of a trigger event. Under IFRS9, the impairment model will become forward-looking: a triggering event is no longer necessary to recognize an impairment. The model is based on expected credit losses on financial instruments. The IFRS9 impairment model requires an entity to assess the probability of default origination/purchase throughout the entire life/maturity of the underlying financial assets. The valuation should be updated continuously to reflect changes in the evolution of credit risk of financial instruments.

24. The IFRS9 impairment model will be applied to all financial instruments that are subject to impairment accounting (assets at amortized costs, assets at fair value through statement of comprehensive income). Considering IFAD’s consolidated financial statements as at 31 December 2015, the IFRS9 impairment model should be applied to:

11 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.
• Loans outstanding and related commitments of US$5,141.5 million; and
• Investment portfolios designated at amortized cost of US$406.7 million.

25. The challenge is posed by the inclusion of a forward-looking impairment methodology in IFAD’s loan portfolio. IFAD’s core business is to invest in rural poverty through loan-financed activities, the majority of which are provided on concessional terms (e.g. highly concessional loans have a maturity period of 40 years including a grace period of 10 years). As shown in figures 1 and 2, IFAD has an excellent debt-servicing track record: loans in provision status are less than 1 per cent of the balance of loans outstanding. Due to positive experiences, IFAD has never written off any balance.

26. Another category of financial assets subject to IFRS9 impairment tests are securities accounted for at amortized cost. In line with IFAD’s Investment Policy, IFAD holds high-quality securities that are well exchanged in official markets. Evidence of the creditworthiness of bond issuers is readily available and embedded in the market price of those securities, even if they are accounted for at amortized cost. As mentioned above (tables 1 and 2), IFAD’s Investment Policy prescribes high-quality investment securities. Moreover, Management has already established a prudent impairment policy to capture signals of deterioration in the creditworthiness of the issuers in a proactive manner (see the annex).

27. Considering the complexity of the requirements and the peculiarities of the accounting procedures for IFAD loans, Management concentrated its efforts on the preliminary analysis of the effects of IFRS9 on outstanding loan balances. During the second quarter of 2016, Management received consultancy services from one of the major audit firms and subsequently undertook a preliminary assessment of the possible impact of IFRS9 on the 2015 accounts. In accordance with IFRS9 requirements, the assessment was undertaken. The assessment placed considerable emphasis on historical information and factored in forward-looking economic scenarios. In this respect Management used rating information available from the major rating firms and based on the prudential recovery rate set for unsecured instruments (commonly set at 60 per cent). Based on this preliminary exercise the additional impairment potentially required under IFRS9 is estimated to range from US$60 million to US$100 million in nominal terms.

28. In accordance with IFRS requirements, the initial impact of the application of IFRS9 will be recorded as part of equity and in particular as a negative effect on retained earnings. It is worth highlighting that this will represent a pure accounting entry with no cash flow repercussions.

29. Management will continue to work during 2016 and 2017 to further strengthen the methodology and the assumptions surrounding the implementation of this accounting principle and will continue to liaise with external auditors to ensure full compliance with the IFRS. Management will also set up systems, tools and procedures to enable implementation.

VII. Summary and options

Option 1: Release of the General Reserve

30. Management proposes that the General Reserve be released.

31. The relevance of the General Reserve has diminished since the adoption of the practice of basing resources available for commitment on the sustainable cash flow approach. The risks of overcommitment are now proactively managed to ensure that there are sufficient liquid assets to cover projected disbursement with a long time-horizon.

32. As reported above, IFAD’s financial situation is sound. IFAD has always been attentive to financial risks and has established specific mitigation strategies for each such risk (currency exposure risk, credit and market risk, and liquidity risk).
33. These considerations suggest that the General Reserve should be released to retained earnings. This would have the accounting effect of compensating for the negative impact caused by the implementation of IFRS9. These transactions would be IFRS compliant.

34. The release of the General Reserve and the additional impairment requirement will not have cash flow consequences, the liquidity position of the Fund will not be affected by these accounting entries.

35. IFAD’s financial situation will remain sound, the ratio of total equity (contributions plus General Reserve) to total assets will decrease slightly from 93.5 per cent to 92.4 per cent in nominal terms (as at December 2015).

36. All financial risk parameters will remain well within the thresholds established by the Sovereign Borrowing Framework adopted in April 2015, as summarized in table 4 below.

Table 4
Financial ratios as at December 2015

<table>
<thead>
<tr>
<th>Ratio</th>
<th>December 2015</th>
<th>Threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity/total assets</td>
<td>93.5%</td>
<td>&gt;60%*</td>
</tr>
<tr>
<td>Revised equity/total assets (if General Reserve is released)</td>
<td>92.4%</td>
<td>&gt;60%*</td>
</tr>
<tr>
<td>Debt/equity</td>
<td>2.0%</td>
<td>&lt;35%</td>
</tr>
<tr>
<td>Revised debt/equity (if General Reserve is released)</td>
<td>2.1%</td>
<td>&lt;35%</td>
</tr>
<tr>
<td>Liquidity</td>
<td>17.8%</td>
<td>&gt;5%</td>
</tr>
<tr>
<td>Liquidity/disbursement needs</td>
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<tr>
<td>Debt service coverage</td>
<td>0.1%</td>
<td>&lt;50%</td>
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</tbody>
</table>


37. Management will remain mindful of financial risks and will continue to report to the Audit Committee and Executive Board about measures taken to mitigate such risks at least once a year as part of the presentation of IFAD’s consolidated financial statements.

Option 2: Maintain the General Reserve, and reconsider the assessment after one year

38. The second option would be to maintain the General Reserve at the current level of US$95.0 million and reconsider its level and purpose in one year’s time, when the assumptions and implications of IFRS9 are more concrete.

39. This is a prudent approach that may also be warranted in light of increasing market volatility, possible scaling up of borrowing activities and the rating exercise.

VIII. Conclusion and recommendation

40. Taking into consideration the sound financial framework within which IFAD is currently operating, Management believes that the risks of overcommitment for which the General Reserve was specifically established are being addressed effectively through operational and financial methods.

41. Therefore pursuit of option 2 is recommended, whereby the General Reserve is maintained as an accounting element of retained earnings at the current level of US$95.0 million, to be reviewed in one year’s time. This will enable the Fund to factor in further considerations deriving from the implementation of IFRS9, increasing market volatility, possible scaling up of borrowing activities and the rating exercise.
IFAD policy on the impairment of financial assets valued at amortized cost and on investments in equity instruments

I. Preamble

1. This policy is adopted to ensure appropriate assessment, recognition and measurement of impairment losses in accordance with International Financial Reporting Standards (IFRS) and International Accounting Standard (IAS) 39. It defines the objective evidence and the process for recognizing and reporting on the impairment of financial assets valued at amortized cost and of investments in equity instruments.

2. The responsibility to set, modify and ensure adherence to this policy rests with the Associate Vice-President, Financial Operations Department (AVP/FOD), Chief Financial Officer and Chief Controller.

II. Evidence of impairment

3. A financial asset is impaired and an impairment loss is incurred only if:
   (i) There is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (i.e. a “loss event”); and
   (ii) The single loss event, or the combined effect of several events, has a material impact on the estimated future cash flows of the financial asset.

4. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset. A significant or prolonged decline in the fair value of an investment could be considered an indicator of objective evidence of impairment.

   Financial assets valued at amortized cost

5. Objective evidence that a financial asset valued at amortized cost could be considered impaired includes observable data for any of the following loss events:
   (i) Significant financial difficulty of the issuer or obligor;
   (ii) A breach of contract, such as a default or delinquency in interest or principal payments;
   (iii) The lender, for economic or legal reasons relating to the borrower’s financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
   (iv) Increased probability that the borrower will enter bankruptcy or other financial reorganization;
   (v) The disappearance of an active market for that financial asset due to financial difficulties.

6. A significant reduction in the current fair value\(^\text{12}\) of the asset – defined as 20 per cent or more of the original cost\(^\text{13}\) – could be considered an indicator of deterioration of the creditworthiness of a security or issuer.

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\(^\text{12}\) Reduction of value is considered versus the original cost in local currency; a reduction derived from the translation of the local currency into another currency (e.g. reporting) is not considered impairment.

\(^\text{13}\) The weighted average cost, as reported by IFAD’s global custodian Northern Trust is used for phased equity or bond purchases.
Equity instruments

7. In addition to points (i) to (v) defined in paragraph 5 above, and as applicable to equity instruments, objective evidence that equity instruments could be considered impaired includes also the following observable data:

(i) A reduction in the current fair value of an equity instrument to below the original cost for a prolonged period of time defined as 18 months or more;

(ii) A significant reduction in the fair value of the asset defined as a reduction of 30 per cent or more of the initial cost.

III. Process and responsibilities

8. In line with IFRS and as defined in paragraphs 5, 6 and 7 above, the Treasurer will ensure that in cases where a financial asset or group of assets is impaired, or follows a negative trend towards impairment, this is promptly noted and reported to the Controller and to the AVP/FOD.

9. The Treasurer will ensure that a monitoring report for financial assets is produced at least quarterly and provided to the Controller and the AVP/FOD.

10. If the fair value of a financial asset falls by 20 per cent or more, as defined in paragraph 6 above, the Treasurer will, in consultation with the Controller, perform a detailed analysis to evaluate whether the deterioration is prolonged and significant, communicate the findings to the AVP/FOD and to the Risk and Compliance Officer, FOD, and take action as required with the approval of the AVP/FOD.

11. An impairment allowance will be set up if the fair value of an equity instrument falls by 30 per cent or more, or if the fair value of an equity instrument remains below the original cost for a period of 18 months or more, as defined in paragraph 7 above.