Document: EB 2018/125/R.47/Add.2
Agenda: 6(f)
Date: 31 October 2018
Distribution: Public
Original: English

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Summary of Amendments to the 2018 IFAD Investment Policy Statement and the Internal Control Framework for IFAD Investments

Note to Executive Board representatives

Focal points:

Technical questions:

Alvaro Lario
Associate Vice-President
Chief Financial Officer and Chief Controller
Financial Operations Department
Tel.: +39 06 5459 2403
e-mail: a.lario @ifad.org

Domenico Nardelli
Director and Treasurer
Treasury Services Division
Tel.: +39 06 5459 2251
e-mail: d.nardelli@ifad.org

Jose Morte Molina
Chief Risk Officer
Financial Operations Department
Tel.: +39 06 5459 2561
e-mail: j.mortemolina@ifad.org

Dispatch of documentation:

Deirdre McGrenra
Chief
Governing Bodies
Tel.: +39 06 5459 2374
e-mail: gb@ifad.org

Executive Board — 125th Session
Rome, 12-14 December 2018

For: Information

Summary of Amendments to the 2018 IFAD Investment Policy Statement and the Internal Control Framework for IFAD Investments

I. Introduction

1. The IFAD Investment Policy Statement (IPS) is reviewed annually by Management. This year, the exercise has been particularly relevant as IFAD prepares to access to the international capital markets and obtain a credit rating.

2. The credit-rating exercise, coupled with the upcoming comprehensive independent financial risk assessment, requires IFAD to review the investment portfolio's risk tolerance levels and governance structure. While in the past IFAD has been successful in reducing these levels – notably an overall reduction in the portfolio conditional value at risk (CVAR) from 9 to 6 per cent – the current risk level has scope for further reduction in order to better align IFAD with other international financial institutions (IFIs).

II. Changes to the IPS

3. The following changes are proposed:

(i) Move from strategic asset allocation (SAA) to a "tranching" approach for the investment portfolio. As part of the overall process to align IFAD with other IFIs, the risk management of IFAD's portfolio has been moved from pure SAA, where precise limits were set for each asset class, to a tranching approach where the portfolio is invested in different layers based on the liquidity needs of the institution. Annex I of this document gives a detailed explanation of the approach.

(ii) Delegation of power from the President to the Chief Financial Officer (CFO). A new actor in the form of the CFO is introduced. While no explicit responsibilities are assigned to the CFO, the President may delegate responsibilities to the CFO, should he/she wish to do so.

(iii) Removal of explicit reference to a procurement process for external fund manager selection. Whether or not to follow a procurement process in this regard is considered to be beyond the scope of the IPS. Reference is made to paragraphs 11 and 12 of the 2017 IPS (see EB 2017/122/R.31).

(iv) Removal of responsibilities for engaging and discharging commercial and central banks for the management of operational cash. As this function relates to operational procedures, it is considered beyond the scope of the IPS. Reference is made to paragraphs 14 and 15 of the 2017 IPS.

(v) Investment management responsibilities better defined. Specific details regarding investment management responsibilities for both internally and externally managed funds were removed as this level of detail is considered to be excessive for a policy document. Instead these details are presented in the internal control framework (ICF).

(vi) General investment objectives re-established. The emphasis on return on investment as an objective was reduced and greater emphasis placed on reducing the volatility of returns.

(vii) Explicit mention of environmental, social and governance considerations. IFAD's compliance with the Ten Principles of the United Nations Global Compact is included.

(viii) Definition of components of investment guidelines, criteria and investment benchmarks is removed. This is considered too detailed and beyond the scope of a policy-level document. Reference to this will be made in the ICF.

(ix) No reference to special drawing right (SDR) alignment. Following the changing financial architecture of IFAD and the increase in single currency lending, it was considered appropriate to eliminate the explicit alignment of IFAD's assets to the SDR basket. More detail regarding the currency alignment procedures is provided in the ICF.

(x) Reference to risk budgeting has been removed. Instead, a broader risk and asset allocation framework is outlined in annex I of the IPS.

(xi) CVAR has been lowered from 6 to 3 per cent. Specific reference to an overall CVAR limit of 6 per cent was removed and replaced by CVAR limit of 3 per cent in annex I. This again underscores IFAD's desire to reduce investment portfolio risk and align its policy to peer IFIs.

(xii) Details of performance measurement and reporting moved. These were considered to be beyond the scope of the IPS and will be moved to the ICF.

III. Changes to the ICF

4. In addition to the overall annual review/updating of the document in alignment with the IPS, , it is important to consider the following:

(i) As per a change in the terms of reference of the Investment and Finance Advisory Committee (FISCO), the Committee's composition detailed in annex I of the ICF was updated.

(ii) Considering the new tranching approach stated in the IPS, the reference to the individual investment portfolios was removed from the ICF. The proposed portfolio structure (tranching approach) and the eligible asset classes are now detailed in the IPS.

5. It should be noted that as a result of IFAD's evolving financial architecture, some limits and policies contained in the ICF are currently under review and might be part of a new extended and holistic framework (i.e. Asset and Liability Framework).

A tranching approach for IFAD's investment portfolio

1. The strategic asset allocation for the IFAD investment portfolio is specified in the 2017 version of the IFAD investment policy statement. Maximum allocations to each asset class are specified with some flexibility provided for occasional deviations.

2. This allocation stemmed largely from an asset allocation study performed by BlackRock in 2015 and has been amended over time to take into account the evolving financial architecture of IFAD. The two main changes that were introduced over the past three years are:

   - The allocations by asset class specified in the Investment Policy Statement (IPS) were changed from mandatory with prescriptive weights to mandatory with indicative weights, so as to allow the Treasury Services Division some flexibility to shift between them. This was approved by the Executive Board during the 2017 annual review of the IPS;

   - Allocations to higher-risk asset classes such as emerging market debt were reduced and replaced by increased allocations to government bonds. This process began in 2016 and is still ongoing.

3. While IFAD has been prudent in reducing the level of risk embedded in the asset allocation, the foundation of asset allocation remains the BlackRock study. The goals and objectives specified in this study were largely driven by IFAD's needs at the time, i.e. to operate more as a fund – and therefore maximize portfolio return after having provided for liquidity and security – than as an international financial institution (IFI) seeking to obtain a credit rating. Hence, risk and return considerations for asset allocation did not take into account the need to reduce risk within the investment portfolio to levels in line with highly-rated IFIs.

4. This approach to asset allocation has not only become dated from a risk management point of view, but also fails to take into account the liquidity needs of the Fund. While the asset classes mentioned in the asset allocation are, for the most part, inherently liquid (e.g. global government bonds) there is no apparent link between the allocation of more versus less liquid asset classes and IFAD's day-to-day liquidity needs and its minimum liquidity requirement (MLR).

5. The proposed solution to complete the process of portfolio re-positioning is to emulate a model followed at other IFIs, notably the International Bank for Reconstruction and Development (IBRD); that is to tranche the investment portfolio based on liquidity needs and a more conservative risk and return profile.

6. According to this solution, the investment portfolio will be composed of four tranches, applying to core funds and borrowed funds, but not supplementary funds. Each tranche will have a list of eligible asset classes, a maximum risk tolerance level and a return benchmark. To implement the proposed solution, it is proposed that five steps be followed.

7. Step 1: Define the objective of each tranche

   - Liquidity tranche – Used for disbursements over the next 30 days.

   - Buffer tranche – Should the liquidity tranche be temporarily depleted due to an unforeseen spike in disbursements, funds in the buffer tranche will be used to fund these outflows.

   - Surplus tranche - These are funds in addition to what is required by the MLR. The surplus tranche is used to provide some return enhancement.

   - Funding tranche – To house borrowed funds, manage them according to an asset-liability management framework and cover the cost of funding. Over time, as IFAD completes its transition to a full IFI business model and access to borrowing becomes more frequent, it is possible that this tranche will be absorbed into the others, leaving only three tranches.

8. Step 2: Determine the size of each tranche – the size of each tranche will be driven by liquidity requirements.

- Liquidity tranche – One-month projected cash outflows from the portfolio.
- Buffer tranche – The difference between the MLR and one-month projected disbursements.
- Surplus tranche – The difference between the size of the portfolio and the MLR.

9. Step 3: Determine the level of risk tolerance and return target for each tranche. The levels of risk and target levels of return for each tranche correspond to the objectives of the relevant tranche. Risk limits on the tranche will ensure that the overall risk level of the portfolio will not increase beyond a conditional value at risk of 3 per cent.

10. Step 4: Determine list of eligible instruments for each tranche. The eligible instruments correspond to the liquidity requirements and levels of risk tolerance for each portfolio.

11. Step 5: Allocate existing sub-portfolios to each tranche. The reduction in risk that will stem from this approach will imply that some sub-portfolios such as the global inflation and emerging market debt portfolios will have to be terminated and a new short-term diversified fixed income portfolio will be created. In addition, the guidelines for each sub-portfolio will have to be amended to incorporate the restrictions placed by each tranche's unique limits.

12. The benefits of the tranching approach are that it:

- Incorporates the liquidity requirements of IFAD into the asset allocation;
- Sets clear risk limits and return targets that correspond to the objectives of each tranche; and
- Does not constrain IFAD by forcing allocations to any particular asset as per a traditional strategic asset allocation. Instead it allows for greater flexibility, within a more conservative risk framework, to enable IFAD to achieve the objectives of its investment portfolio.