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Approach to IFAD's New Liquidity Policy: Principles and Guidelines

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Abbreviations and acronyms

AFD	Agence Française de Développement
AfDB	African Development Bank
AfDF	African Development Fund
AfIB	Asian Infrastructure Investment Bank
AsDB	Asian Development Bank
CPL	concessional partner loans
DFI	development finance institution
EBRD	European Bank for Reconstruction and Development
IDB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFAD9	Ninth Replenishment of IFAD's Resources
PoLG	programme of loans and grants

Executive summary

1. IFAD has traditionally relied on Member State contributions to finance its programme of loans and grants (PoLG). Since its Ninth Replenishment of IFAD's Resources however, IFAD has gradually become more dependent on its capacity to generate internal resources (i.e. reflows) and on borrowing. The introduction of borrowing has strengthened IFAD's ability to project an expanded PoLG, and increase its commitments to recipient countries.¹
2. Recent independent assessments of IFAD's financial architecture have pointed to the need for IFAD to consider new sources of funding in order to enhance its financial efficiency and sustainability. A report by Alvarez & Marsal presents this as a fundamental decision for IFAD's long-term financial capacity. Despite the Fund's increased borrowing, IFAD's liquidity position has been decreasing over the last replenishments due to its limited capacity for generating internal resources. This calls for an enhanced approach to liquidity management going forward.
3. By revising its liquidity management principles, Management is attempting to enhance IFAD's financial structure in line with best practices of peer development finance institutions. The upcoming revision of IFAD's Liquidity Policy is a major part of the review of the Fund's financial architecture. This paper lays out the rationale and objectives of the review, and provides guidelines for future implementation in the Twelfth Replenishment of IFAD's Resources.
4. The objective of the ongoing review is to adjust the definition of liquidity at IFAD in order to ensure that the Fund is able to meet all payment obligations without Members' or external lenders' support in the short term – even in the context of stressed conditions for borrowers and markets. One key change involves shortening the time period for which liquidity is needed from the current policy's long-term approach.
5. The second element Management is examining is the need to address risks that may arise from IFAD expanding debt funding of its PoLG through the existing sovereign borrowing programme, concessional partner loans and potential debt instruments.

¹ As of June 2019, IFAD's commitments from previous replenishments cycles amounted to US\$4.7 billion. It is estimated that US\$2.6 billion will be disbursed during IFAD11.

I. Background and rationale for a revision of IFAD's Liquidity Policy

A. IFAD's current Liquidity Policy

1. IFAD's Liquidity Policy was approved by the Executive Board in November 2006.² The purpose of the policy was to: (i) ensure that the Fund had adequate liquidity to meet its obligations (i.e. disbursements for loans, grants and administrative expenses) at all times, even in the unlikely event that all the liquidity shocks from stress tests occur in the same year; and (ii) define IFAD's commitment capacity in line with the sustainable cash flow approach introduced during the Ninth Replenishment of IFAD's Resources (IFAD9).³
2. The policy requires that IFAD maintain, at all times, minimum liquidity equal to 60 per cent of projected annual cash outflows and potential additional requirements resulting from liquidity shocks.⁴ For calculation purposes, the term "liquidity" referred at that time to "highly liquid assets" – an asset class that included short-term instruments and government securities, which could be converted to cash quickly without significant loss of value.
3. The 2006 Liquidity Policy was developed at a time when IFAD's only funding source was Member States' replenishment contributions. Since 2006, the regulatory environment for financial institutions has evolved, and best practices applied by development finance institutions (DFIs) following the global financial crisis have been shared. New regulatory frameworks have been implemented to promote a more resilient financial system with greater ability to absorb financial shocks. DFIs have adopted changes based on these lessons learned, and credit rating agencies have adjusted their methodologies to the new ways of computing liquidity.

B. IFAD's new resourcing landscape

4. Debt was introduced into IFAD's funding model for the first time during IFAD9, when IFAD established a Sovereign Borrowing Framework and obtained a sovereign loan from KfW Development Bank. During IFAD10, IFAD entered into another sovereign debt arrangement with the Agence Française de Développement (AFD). Finally, during IFAD11, additional resources were added in the form of concessional partner loans (CPLs) to diversify IFAD's funding sources.
5. In 2018, IFAD engaged in a comprehensive reform of its financial architecture. This process, which aimed to allow IFAD to expand its operational delivery with consideration to financial sustainability, is based on the need to strengthen IFAD's financial position and risk management capacity in line with the recommendations of two independent assessments of IFAD's financial structure:
 - (i) A corporate-level evaluation of IFAD's financial architecture undertaken by the Independent Office of Evaluation of IFAD;⁵ and
 - (ii) An external independent assessment of IFAD's financial risk management undertaken by the consulting firm Alvarez & Marsal.

C. Rationale for a new Liquidity Policy

6. Both these assessments recommended that in order for IFAD to continue to operate at its current level and grow its operational capacity sustainably, it must access additional sources of funding.

² See EB 2006/89/R.40.

³ The IFAD9 Consultation adopted a sustainable cash flow approach as the basis for committing to the proposed programme of loans and grants (PoLG). This approach considers cash flow sustainable if, over the next 40 years, all inflows and outflows derived from the currently estimated future PoLGs and related obligations never breach the minimum liquidity requirement stipulated in IFAD's Liquidity Policy.

⁴ See EB 2006/89/R.40, section V.12.

⁵ Presented to the Executive Board in 2018; see EB 2018/124/R.7.

7. The Alvarez & Marsal report pointed out that liquidity is intended as a management tool for between one and three years; therefore, projecting its evolution over a 40-year period based on long-term assumptions is not an appropriate tool for making management decisions about future resources.
8. A recent strategic transformation at IFAD aimed at maximizing its development impact has created the need for a more robust liquidity and capital management framework. As IFAD's capital structure continually evolves through increased leverage, new issues such as interest rate repayment obligations, shorter-term debt and refinancing of debt rollover need to be considered when defining the time horizon in order to measure liquidity requirements more accurately.
9. This new resource mobilization model requires a more sound liquidity management framework, necessitating a change in the Liquidity Policy in order to cover net outflows over a shorter time horizon, along with more in-depth short-term stress scenarios. This increased focus on stressed conditions is a lesson learned from the 2008 financial crisis, when disbursement patterns changed, non-performance and defaults increased, and some liquid investments decreased in value.
10. Management has finalized the formulation and proposal of a Capital Adequacy Policy for IFAD as a new tool to manage resources. The incorporation of capital planning also requires a new look at liquidity risk management. Capital will now be the fundamental pillar of IFAD's long-term sustainability while liquidity will focus on the short- and medium-term availability of funds. This is in line with the practice of peer DFIs in which the time horizon covered by their liquidity policies spans 12 to 24 months.⁶ Comprehensive medium-term cash projections also remain necessary to monitor the behaviour of the liquidity determinants, supplemented by stress testing.

II. Issues to address

A. Objectives

11. The objective of the Liquidity Policy is to ensure that the Fund has the ability to honour all its financial obligations as they fall due over a short-term time horizon.
12. The short-term horizon functions as an anchor while the medium-term liquidity horizon is focused on analysis, planning and reporting of future short-term liquidity. In the medium term, Management will need to monitor and plan disbursements carefully, as well as be realistic about contributions and borrowing transactions.
13. Medium-term planning and vigilance in maintaining sufficient liquidity to withstand shocks in the short term supports the organization's long-term sustainability.

B. Cash flow coverage

14. IFAD's main inflows are composed of loan reflows, Member contributions and the borrowing of funds. Its financial outflows primarily comprise disbursements for approved and committed loans and grants, administrative expenses and debt servicing. Table 1 below shows the main components of IFAD's sources and uses of cash.
15. The current Liquidity Policy focuses on gross outflows of funds to be covered. At the time of formulation, the outflows were more granular, with no borrowing taking place. With more irregular and larger repayments on borrowing transactions, it is prudent to take into account inflows as well as 100 per cent of outflows for the chosen short-term horizon. The new definition of liquidity will focus on net outflows rather than on gross outflows.

⁶ Annex I describes the minimum liquidity requirement used by peer DFIs.

Table 1
IFAD's main inflows and outflows

Cash inflows	Cash outflows
Encashment of donors contributions	Disbursements for loans
Encashment of Debt Sustainability Framework (DSF) compensation	Disbursements for grants
Loan reflows	Disbursements for DSF
Investment income	Administrative expenses
Withdrawals from sovereign borrowing facilities and CPLs	Debt service of sovereign borrowing and CPLs

C. What constitutes a liquid asset?

16. Cash, or assets readily convertible to cash, provide liquidity and are collectively referred to as "liquid assets".
17. In general, DFIs need to manage the timing mismatch between readily available cash inflows and cash outflows occurring in the future. The largest proportion of cash is normally invested in debt securities in compliance with these institutions' investment policies, while a smaller proportion is kept as deposits with banks, sometimes on a collateralized basis. When a disbursement commitment is about to fall due, the DFI sells one or more securities in its investment portfolio, obtaining sufficient proceeds to honour its payment obligation. In order to minimize market risks, this liquidation is executed in advance of the commitment that is due.
18. Liquid assets refer to all assets managed by the treasury, but while cash and short-term placements with banks can be considered liquid, the same cannot always be assumed of other investments. Credit quality, industry classification of the issuer, and maturity (tenor) affect the marketability of a security, and therefore the ease with which it can be sold and the price.
19. IFAD's Investment Policy supports the Liquidity Policy by defining the investment guidelines to limit risk taking, and ensuring that funds are directed towards investments that are liquid.

D. Time horizon

20. As outlined in section I, IFAD's current liquidity framework has become outdated and cannot adapt to the needs of IFAD's new financial architecture. According to the sustainable cash flow approach,⁷ "A certain level of PoLG is defined as cash flow sustainable if, over the next 40 years, forecasting all of the inflows and outflows derived from the current and future PoLGs and related obligations, IFAD's liquidity (i.e. the balance of its cash and investments) never breaches the minimum liquidity requirement".
21. A greater focus on short-term stress levels and IFAD's increasing reliance on borrowing makes it inefficient to maintain the present a level of liquidity, which complies with the minimum liquidity requirement each year for 40 years. The current model may inflate present borrowing needs, forcing IFAD to borrow more today in order to be sustainable over 40 years.
22. The current approach does not allow for the efficient use and management of IFAD's resources. Financial projections over the long term rely on predefined assumptions while impacts on cash flows – including the need to bridge funding gaps – might crystallize in the distant future. A forecast of future investment returns, interest rates or even Member contributions beyond a medium term of two

⁷ EB 2013/108/R.20 – Procedures and definitions for determining resources available for commitment based on sustainable cash flow.

to six years does not allow for high reliability or accuracy of the financial model's assumptions and inputs.

23. Given the current transformation of IFAD's financial architecture, it seems logical to explore the short-term horizon used by peers and required by credit rating agencies. There is no common time horizon used by the comparator DFIs in their liquidity policies. A one-year horizon is the most common, but the European Bank for Reconstruction and Development (EBRD) and the International Development Association (IDA) both measure liquidity over a two-year horizon, while the African Development Fund (AfDF) covers 50 per cent over three years. Furthermore, the level of liquidity coverage required should be considered in tandem with the horizon period chosen. For example, a coverage ratio of 100 per cent of cash flow requirements over the next one year is comparable to a 50 per cent ratio of cash flow requirements over the next two years, assuming each year has a similar net cash requirement. Using this approach, the liquidity coverage of the referenced DFIs typically ranges between 1 and 1.5 years equivalent, with IDA the most conservative at 19 months.
24. Using a lower percentage than 100 per cent for a longer horizon stabilizes the liquidity requirement, but when cash flows differ between years, this simplification may lead to inaccurate estimates of liquidity requirements.

E. Stress tests

25. To assess an institution's liquidity profile, a distinction must be made between the assessment of liquidity under normal operating conditions and liquidity assessed under stressed conditions. To account for this discrepancy, it has become standard practice to apply discounts – technically known as "haircuts"⁸ – to asset values and other liquidity sources. These are driven primarily by credit rating, type of issuer and maturity of the asset in question. In addition, liquidity outflows must be stressed in such a way that the institution can withstand an increase in disbursements of committed loans as reflows slow down and liquidity investments decrease in value.
26. A stressed liquidity position is designed to take into account events that are unlikely to occur in a normal operating environment, but for which readiness and self-sufficiency are required.
27. IFAD's current Liquidity Policy is based on a single minimum liquidity requirement in which stressed cash flow conditions have already been included. However, the current approach is outdated since it does not apply the haircuts imposed by credit rating agencies or peer organizations.
28. The peer DFI group comprises borrowers in international capital markets, which are subject to annual assessments by major credit rating agencies. In assessing the strength of their liquidity position, these agencies examine organizations' ability to meet all their financial obligations under stressed conditions for up to one year. The most common stressed liquidity ratio used by the peer DFI group is measured over a one-year horizon in line with credit rating agencies' stress test. But some organizations extend the horizon for which the liquidity is required by up to two years.
29. IFAD will tailor its liquidity approach to its current financial architecture and instruments in preparation for its credit rating exercise. The Fund will therefore focus on a combination of stressed short-term liquidity and intermediate medium-term liquidity that will serve as a guide for liquidity planning and monitoring.

⁸ Credit rating agencies apply haircuts when evaluating the strength of a rated entity's liquidity.

F. Minimum and target liquidity

30. A common practice among peer DFIs is to have two layered limits with different levels of reaction in case they are broken. A minimum limit should never be broken in the normal course of business; if this does occur, a contingency plan should be activated. A target that leaves a buffer zone above the minimum can be used with the knowledge of Management and with an action plan to return to regular levels.

G. Other issues

31. Annex III introduces monitoring and reporting requirements of the Liquidity Policy.

III. Conclusions and way forward

32. Given the aforementioned challenges, Management is working to implement an updated Liquidity Policy with clearer objectives that would enable IFAD to carry out its mandate into the future. To this end, Management is evaluating the possibility of incorporating the following liquidity management practices:

- (i) Time horizon and objective. IFAD will adapt a new objective for the Liquidity Policy, with a focus on the short term and an overarching goal of holding sufficient liquidity to enable the Fund to meet its obligations without the need to request supplementary encashment, even in stressed conditions.
- (ii) Limits. Management is evaluating the need for different limits to manage liquidity, including a:
 - Positive cash flow limit for the very short term (30-60 days);
 - Prudential minimum liquidity level at 15–24 months; and
 - Target liquidity limit at 24–36 months.
- (iii) Cash flows. Basing liquidity needs on net cash flows, the minimum volume of liquid assets held by the Fund will be managed in compliance with its capital adequacy and its capacity to access external funding sources.
- (iv) Source of funding. Debt shall be recognized and included in the computation of resources available for commitment as an additional source in conjunction with internally generated flows and encashment receipts. The ongoing review of liquidity management suggests that the amount of liquidity IFAD should carry largely depends on its capacity to access funding in a timely manner.
- (v) Liquidity planning. Management will implement a robust framework to ensure the adequate level of liquidity over the medium term (two to six years) by monitoring its internal resources and defining funding mechanisms that are aligned with the projected and realized PoLG. This planning will complement capital planning as envisaged in the Capital Adequacy Policy and both will serve as pillars of IFAD's sustainability over the long term.
- (vi) Stress tests. It is necessary to define a horizon for IFAD's self-sufficiency under stressed conditions by applying haircuts to incoming payments along with investments and accelerated disbursements. Stress-testing scenarios will include:
 - Acceleration of disbursements (e.g. up to 50 per cent over the next one year or worst case historical scenario);
 - Slowdown in repayments, increase in defaults and non-performance or restructuring (e.g. using probability of default factors to apply haircuts to loan reflows);

- Haircuts to be applied to promissory notes and instruments of contribution recognized on the balance sheet;⁹
 - No new Sovereign Borrowing Framework or CPL borrowing; and
 - Administrative expenses and maturing of borrowing according to budget and schedule.
- (vii) Contingency plans. IFAD will define contingency plans for liquidity crisis management. These plans must provide a clear and rapid explanation of responsibilities and potential actions to be taken in case of foreseen or actual liquidity crises.

⁹ A haircut of Member contributions could be considered in certain scenarios for a prudent definition of normal liquidity. The objective is to anticipate any potential delays in the payment of pledged amounts when IFAD does not have any formal payment schedule or instrument of contribution. This approach is in line with the practice at IDA for defining cash inflows under normal conditions.

Peer comparison of liquidity policies

DFI	Liquidity Policy
IBRD	The liquidity policy stipulates that liquid assets must equal to at least the highest consecutive six months of anticipated debt service plus one half of the anticipated net loan disbursements over the fiscal year, if positive.
IDA	IDA's liquidity policy is to have minimum liquidity equal to 80 per cent of 24 months of projected net outflows. (This definition was changed following the introduction of funding from capital markets. Previously, it was 33 per cent of a three-year annual moving average of gross disbursements.)
AfDB	The bank's policy requires it to meet its net cash flow requirements (including debt-service payments, net loan disbursements, the notional value of committed guarantees and the value of undisbursed equity investments) over a rolling one-year horizon without recourse to capital markets.
AfDF	Minimum liquidity is set at 50 per cent of the three-year moving average of net disbursements.
AsDB	Minimum liquidity is set at 45 per cent of the three-year net cash requirements to cover net cash requirements for 18 months under normal and stressed situations without borrowing.
AIIB	Liquidity must be sufficient at any time so that at least 40 per cent of the next three years' net cash requirements can be met without recourse to funding markets.
IDB	The bank's liquid assets must cover at least 12 months of projected net cash requirements, after accounting for liquidity haircuts.

Peer comparison of liquidity ratios

	IFAD*	IDA	AfDB	IBRD	AsDB	EBRD	IDB
Liquid assets / adjusted total assets (%)	13	18	37	18	16	47	25
Liquid assets/gross debt (%)	182	501	52	35	35	71	36
Liquidity coverage ratio (with planned disbursements):12 months (net derivate payables)	1.2	2.6	1.7	1.2	1.8	1.2	1.4
Total assets (US\$ billion)	8	206	47	403	192	71	129

Monitoring and reporting

1. IFAD's current Liquidity Policy establishes that the Fund's liquidity status must be monitored and reported through the Fund's regular reports on its investment portfolio.
2. The new Liquidity Policy should provide more details about measures to anticipate potential breaches through the implementation of triggers as early-warning indicators (e.g. liquidity ratios and stressed liquidity horizon).
3. While the new Liquidity Policy will be measured on a shorter time frame, it is clear that the management of cash flow requirements is a daily, weekly and monthly exercise that should occur continuously throughout the period. Reporting of investment portfolio liquidity contribution on a daily basis is recommended, while monthly updates on IFAD's operating cash flows should suffice.
4. Monitoring and reporting should be undertaken on a forward-looking basis, and reporting should stretch well beyond the short-term horizon in order to provide Management with opportunities to plan and react in time. Planning of IFAD's PoLG must be harmonized with funding plans and deviations from plans discussed with Management.
5. The Treasury Services Division will adopt a liquidity-based approach to its investment portfolio, common at other DFIs, with the portfolio structured as follows:
 - (i) Liquidity tranche – for disbursements over the next 30–60 days, mostly consisting of deposits, reverse repos, certificates of deposits, commercial paper and treasury bills;
 - (ii) Buffer tranche – together with the liquidity tranche, holds the liquidity required to achieve the target liquidity under stressed conditions; and
 - (iii) Surplus tranche – holds assets in excess of the target liquidity needed under stressed conditions, thereby offering scope for higher returns.
6. Ratios will be calculated by the Treasury Services Division and monitored by IFAD's Risk Management Unit periodically. Examples of ratios for monitoring liquidity include the following:
 - (i) Liquid assets to total assets ratio – the ratio of cash and bank deposits plus investments to total assets, expressed as a percentage;
 - (ii) Liquidity cover – the ratio of cash and bank deposits plus investments to the prudential minimum liquidity requirement, expressed as a number;
 - (iii) Stressed liquidity coverage ratio – the ratio of the amount of liquid assets over stressed cash outflows over a six-month period; and
 - (iv) Debt-service coverage ratio – the ratio of cash and bank deposits plus investments, less administrative expenses to payments of interest and principal on all borrowing facilities.