
Capital Adequacy Report – June 2022

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Action: The Executive Board is invited to review the content of the report.

Technical questions:

Alberto Cogliati

Associate Vice-President and Chief Risk Officer
Office of Enterprise Risk Management
e-mail: a.cogliati@ifad.org

Jose Joaquin Morte Molina

Lead Financial Risk Officer
Office of Enterprise Risk Management
e-mail: j.mortemolina@ifad.org

I. Executive summary

1. The Capital Adequacy Report is a semi-annual document submitted to the Financial Risk Management Committee, the Audit Committee and the Executive Board with the aim of providing a synopsis of IFAD's capital consumption and trends in its deployable capital (DC) ratio. The information provided in this report helps the Board and the Committees to supervise implementation of the Capital Adequacy Policy and verify compliance with the limits established in the exposure management framework.
2. DC is the main metric used to assess IFAD's capital utilization and the availability of resources to support future commitments. The DC ratio is defined as the amount by which the total initial capital available (ICA) exceeds expected and unexpected losses stemming from IFAD's operations, i.e. the total resources required (TRR), plus a prudent buffer that is expressed as a percentage of the ICA.
3. As at June 2022, IFAD was compliant with all the risk limits established in the exposure management framework¹ set out in the Capital Adequacy Policy, as shown in table 1.

Table 1
Compliance with limits and ratios

	<i>Limit (%)</i>	<i>Dec 2021 (%)²</i>	<i>Jun 2022 (%)</i>
Strategic limit			
DC	>0	40.2	39.7
Target limits			
Leverage ³	35-50	19.5	24.8
Core risk capital consumption	<80	47.2	47.4
Non-core risk capital consumption	<10	2.7	2.9
Prudential limit			
Single country limit	<20	8.2	8.3

II. IFAD's risk-bearing capacity

4. IFAD's ability to support its development operations, i.e. its risk-bearing capacity, is a function of its ICA. The ICA constitutes the starting point for assessing IFAD's capital adequacy and is defined as its nominal equity (contributions + retained earnings),⁴ adjusted by contributions and promissory notes receivable,⁵ plus the outstanding allowance for loan impairment losses.
5. Increases in IFAD's risk-bearing capacity mainly reflect contributions received in cash, making the timely encashment of contributions and promissory note receivables an important factor in IFAD's management of its capital. As at June 2022, the ICA had decreased by US\$257.7 million (3.3 per cent) over December 2021, primarily as a result of the US\$587.5 million net losses, which were partially offset by the US\$332 million⁶ in cash payments received in the form of contributions. It should be noted that 2022 net losses include US\$360 million unrealized losses derived from currency exchange movements, which mainly reflect the depreciation of special drawing rights (SDR) against the United States dollar.

¹ See annex IV for formulas and definitions of limits.

² December figures were amended due to a correction in the computation of FX capital requirements.

³ Financial liabilities to ICA. See annex IV.

⁴ General reserves minus accumulated deficit.

⁵ Instruments of contribution not yet paid in cash are registered as equity and as a receivable. For capital adequacy purposes, the ICA reflects only the portion already paid in cash.

⁶ Cash contributions received in 2022.

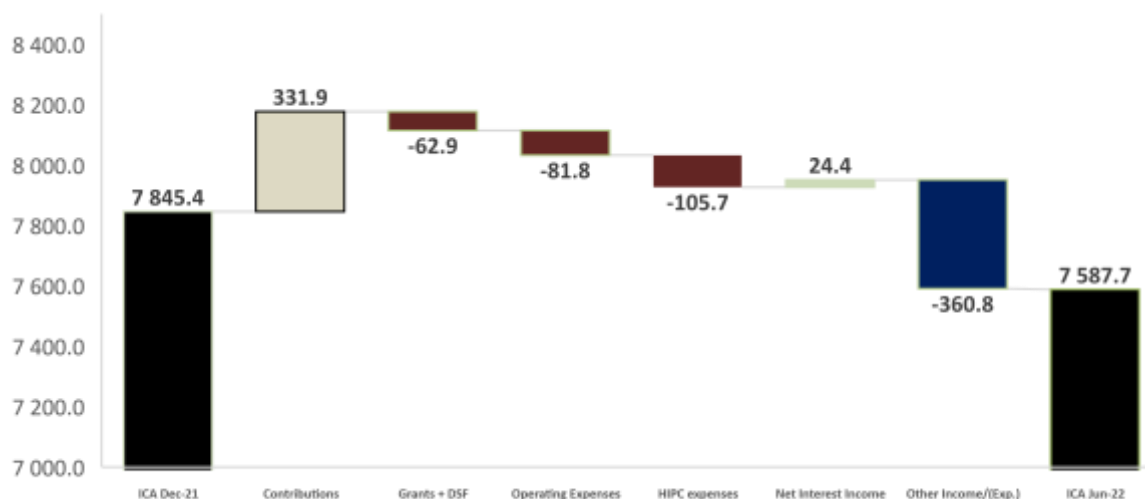
Table 2
Total ICA
(Millions of United States dollars and percentages)

	Dec 2021	Jun 2022	2022 versus 2021	2022 versus 2021 (%)
Shareholder contributions	10 104.0	10 176.8	72.8	0.7
Retained earnings	(1 519.8)	(2 107.3)	(587.5)	38.7
Total equity	8 584.1	8 069.5	(514.6)	(6.0)
Plus: Contributions and promissory note receivables	(842.2)	(583.1)	259.1	(30.8)
Plus: Allowance for loan losses*	103.5	101.3	(2.2)	(2.1)
Total ICA	7 845.4	7 587.7	(257.7)	(3.3)

* Excluding specific allowances for debt relief for Haiti and the Heavily Indebted Poor Countries Initiative.

6. As can be seen in figure 1, an upward trend in the capital available is possible as long as cash payments derived from IFAD's replenishment contributions cover its operational costs, regular grants and disbursements of Debt Sustainability Framework (DSF) operations. Net interest income helps to offset a portion of operational expenses. In 2022, IFAD's Executive Board approved decision point debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative for the Republic of Sudan and the Federal Republic of Somalia, which is reflected in the US\$105.7 million HIPC expenses reported in IFAD's financial statements for June. This amount is expected to be offset over time through the HIPC Trust Fund managed by the World Bank and donor contributions.

Figure 1
ICA in 2021 and 2022
(Millions of United States dollars)



III. Deployable capital

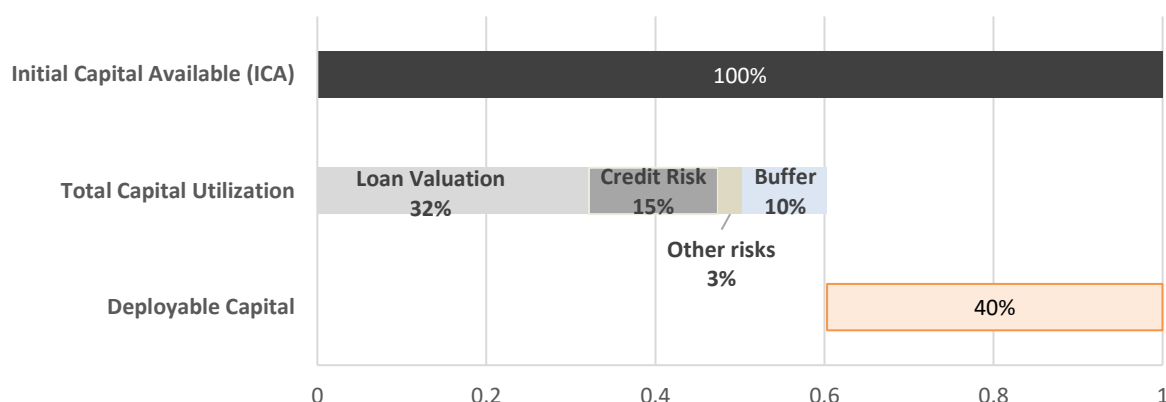
7. The DC ratio is IFAD's key strategic capital adequacy limit. This ratio must be above 0 per cent. As at June 2022, the DC ratio had decreased by 0.4 percentage points from its December 2021 level, falling to 39.7 per cent. This is still well above the 0 per cent limit. A 40 per cent DC ratio indicates that 60 per cent of IFAD's capital would be required to absorb expected and unexpected losses derived from current operations, plus a prudent buffer, while the remaining 40 per cent would still be available to support future operations.

8. As at June 2022, the TRR to support IFAD’s core and non-core risks and to maintain the prudent buffer had decreased by US\$120.3 million (2.6 per cent) over December 2021. The decrease is mainly attributable to the decline in capital utilization for core risks, which accounted for US\$106 million (see annex II).

Table 3
Deployable capital
(Millions of United States dollars and percentages)

	Dec 2021	Jun 2022	2022 versus 2021	2022 versus 2021 (%)
ICA	7 845.4	7 587.7	(257.7)	(3.3)
TRR	3 910.0	3 815.5	(94.5)	(2.4)
Buffer	784.5	758.8	(25.8)	(3.3)
Total capital utilization (TRR + buffer)	4 694.6	4 574.3	(120.3)	(2.6)
DC (ICA-TRR - buffer)	3 150.9	3 013.4	(137.4)	(4.4)
DC as a percentage of ICA	40.2	39.7		(0.4.)

Figure 2
Decomposition of total capital utilization and deployable capital⁷
(Percentages)



9. As at June 2022, IFAD’s ICA to support core and non-core risks amounted to US\$7.6 billion. This was a decrease of 3.3 per cent compared to December 2021. The decrease was primarily the result of the semi-annual net losses. It should be noted that such losses include unrealized losses derived from currency exchange movements, and the increase in the allowance for the HIPC Initiative as explained in the previous section of this report.
10. An upward trend in available capital is key to IFAD’s long-term sustainability and it can continue as long as IFAD’s replenishment contributions cover its operational costs, regular grants, DSF operations, HIPC expenses not covered by the HIPC Trust Fund or additional contributions, and any other capital transfer directly impacting IFAD’s equity.
11. IFAD’s DC ratio decreased from 40.2 per cent in December 2021 to 39.7 per cent in June 2022. This modest decline is mainly explained by the combined effect of declining ICA and additional capital requirements for non-core risks. It should be noted that in the medium term DC is expected to decrease as IFAD gradually increases its leverage ratio.

⁷ See annex II for additional details.

12. IFAD's leverage ratio increased from 19.5 per cent in December 2021 to 24.8 per cent in June 2022. This ratio is gradually approaching the 35 per cent limit established in the Integrated Borrowing Framework (IBF). It should be noted that the Capital Adequacy Policy establishes a conservative indicative range applicable to IFAD's leverage ratio of between 35 and 50 per cent.
13. IFAD's core risks, measured as a percentage of its available capital, reached 47.4 per cent in June 2022 from 47.2 per cent in December 2021. This is fully compliant with (and well below) the maximum target limit of 80 per cent set in the Capital Adequacy Policy. The stability observed in the core risks capital consumption is mainly attributable to the translation effect of currency exchange movements in the exposure at default (EAD). The concessionality of the loan portfolio is the main core risk, accounting for 32 per cent of available capital (68 per cent of core risks).
14. Non-core risks increased to 2.9 per cent of the capital available in June 2022, compared to 2.7 per cent in December 2021. This remains well within the 10 per cent limit. The increase in non-core risk is mainly attributable to the volume effect of a higher investment portfolio. IFAD Management's objective is to reduce capital allocation to non-core risks as much as possible so that it can devote more capital to IFAD's core development operations.

IV. Stress tests

15. Management periodically conducts stress tests to identify potential weaknesses in the capital measures and exposure framework and to provide insights into how specific extraordinary but plausible events could affect the Fund's capital ratios.
16. Since the approval of the Capital Adequacy Policy in 2019, Management has placed an emphasis on monitoring two types of stress events: **credit deterioration and grant activity**. The former is assessed through a scenario in which the loan portfolio is downgraded several notches, and the latter represented by a hypothetical acceleration of DSF disbursements. In both cases, the capital buffer (10 per cent) is considered to be large enough to provide adequate protection against the potential impact associated with these severe credit risk scenarios.
17. In light of the evolution of IFAD's operational environment, a complementary sensitivity stress test was performed to measure the risks of a **potential deterioration of IFAD's preferred creditor status**. The current crisis environment increases the downside risk of IFAD's loan portfolio, which could lead to higher non-performing loans affecting IFAD's preferred creditor status (PCS), which ultimately supports the probability of default (PD) and loss given default (LGD) assumptions utilized to compute credit risk capital charges. To assess the impact of this event, the PCS enhancement implied in the parameters utilized to compute capital charges has been removed. As a result, DC was materially impacted by 14.5 percentage points. It should be noted that the analysis is hypothetical and for illustrative purposes only. The current arrears performance supports IFAD's strong PCS.
18. **Impact of the rising interest rate environment on IFAD's capital requirements.** The Capital Adequacy Policy states that loan portfolio interest rate risk will be monitored in order to guarantee that the stressed interest rate utilized to compute the net present value of the concessional loan portfolio is sufficient to account for both current market valuation and potential losses derived from adverse movements in interest rates, in accordance with prevailing market conditions. The current approach to account for the loan portfolio valuation and interest rate risk in the loan portfolio requires a US\$2.4 billion haircut, which is sufficient to cover the valuation of the concessional portfolio at current market rates (approximately US\$1.2 billion) and an additional 250 basis points (bps) increase in interest rates. Despite the fact that the 5 per cent stressed interest rate

is considered sufficient, the potential impact of a change in such assumption has been included in the stress test analysis. In the event that IFAD decides to increase the stressed interest rate from 5 to 6 percent, the additional capital requirement would be approximately 3.9 percentage points.

Table 4

Stress test sensitivity analysis

(Millions of United States dollars and percentages)

<i>Description of the stress test</i>	<i>Estimated effect on DC ratio (%)</i>	<i>DC as at Jun-22</i>
Base	-	39.7
Increase of 100 bps to the 5 per cent stressed discount rate (from 5 to 6 per cent).	(3.9)	35.8
Three-notch downgrade of the entire portfolio	(6.1)	33.6
Accelerated disbursements of undisbursed signed DSF operations with conditions for disbursement not yet met	(9.1)	30.6
Accelerated disbursements of all undisbursed approved DSF operations	(11.5)	28.2
PD + LGD with no PCS	(14.5)	25.2

V. Conclusions

19. The results for IFAD's capitalization as at June 2022 were broadly satisfactory and in line with best practices and peer institutions. The DC ratio of 39.7 per cent indicated that IFAD's current capital position is sufficiently strong to absorb potential losses arising from its development operations.
20. Notwithstanding its strong capitalization, as it gradually increases the extent of loan operations that are financed by borrowing, IFAD's DC ratio is expected to decrease over time. The size and composition of the programme of loans and grants in each replenishment cycle will determine the pace at which capital is consumed.
21. IFAD's leverage ratio is gradually approaching the 35 per cent limit established in the IBF. This ratio is expected to be reassessed with the update of the IBF and it should be noted that the Capital Adequacy Policy establishes a conservative indicative range applicable to IFAD's leverage ratio of between 35 and 50 per cent. This range was originally proposed as an indicative reference for planning purposes, and indicates that IFAD's capitalization will not be compromised if leverage is maintained within those levels.
22. Management periodically conducts stress tests to assess how certain extraordinary events could affect the DC ratio. Management performed a sensitivity stress analysis on a potential deterioration of IFAD's PCS. The analysis confirmed that PCS is one of the most critical elements affecting the DC ratio. It is worth noting that the analysis is hypothetical and for illustrative purposes only. The current arrears performance supports IFAD's strong PCS.
23. In light of the rising interest rate environment, IFAD is allocating the necessary capital to take into account interest rate risk in the concessional loan portfolio.
24. The capital requirements for non-core risks will continue to be contained as a result of IFAD's conservative financial policies, so that the Fund can devote more capital to IFAD's core development operations.

IFAD's asset characteristics and sources of risk

- ⇒ As a development finance institution, IFAD assumes and manages the financial risks inherent in its operations.
- ⇒ IFAD offers loans to countries on various financial terms. Its loans are primarily made on a concessional basis, have a range of different maturities and are denominated in different currencies.
- ⇒ In line with IFAD's mandate, its loans are primarily granted on highly concessional terms (below-market interest rates). This results in implicit economic losses in the nominal loan portfolio when it is assessed in present value terms while applying market rates.
- ⇒ In support of various development objectives, IFAD maintains liquid assets in its investment portfolio to preserve the Fund's commitment capacity and meet its cash flow obligations. As is also true of its loan operations, IFAD's liquid assets are exposed to credit and market risk.
- ⇒ **Risk associated with the composition of IFAD's balance sheet and off-balance sheet commitments needs to be supported by capital.**

Balance sheet exposures

Table 1

IFAD's simplified balance sheet⁸ as at June 2022 and December 2021

(Millions of United States dollars)

Assets	Jun 22	Dec 21	Liabilities and equity	Jun 22	Dec 21
Cash and investments	1 849	1 408	Borrowing liabilities	1 882	1 527
Net contributions and promissory note receivables	583	842	Other liabilities	455	485
Outstanding loans	7 925	8 234	Total liabilities	2 337	2 012
Allowance for loan losses	(117)	(119)	Contributions	10 177	10 104
Allowance for the Heavily Indebted Poor Countries Initiative	(109)	(5)	General reserve and retained earnings ⁹	(2 107)	(1 520)
Other assets	275	238	Total equity	8 069	8 584
Total assets	10 406	10 596	Total liabilities + equity	10 406	10 596

<i>Income statement</i>	Jun 22	Dec 21	Jun 21
Total revenues	35	117	48
Interest expenses	(4)	(3)	(1)
Operating expenses	(82)	(184)	(81)
Grant expenses	(5)	(32)	(11)
DSF expenses	(58)	(164)	(92)
HIPC expenses	(106)	(2)	(1)
Contributions to other initiatives ¹⁰	0	(69)	0
Other income (expenses)	(367)	(218)	(121)
Net income (deficit)	(587)	(553)	(259)

- ⇒ Given that IFAD primarily works with concessional loans and grants, **its capacity to generate internal capital is limited. Equity is therefore its main constrained resource, and the principle of capital preservation (minimization of losses) must thus be a key element of its financial strategy**, along with fresh capital injections in the form of contributions from Member States.

Off-balance sheet loan commitments

1. Undisbursed balances of approved loans are off-balance sheet commitments that are considered to be credit exposures. They are converted into credit exposures using a specific CCF. For capital adequacy purposes, undisbursed loans do not include loans that are approved but have not yet met disbursement conditions.

Table 2

Undisbursed loans¹¹

(Millions of United States dollars)

	Jun-22	Dec-21
Undisbursed loans	3 198.3	3 247.9

⁸ IFAD-only nominal balance sheet and income statement.

⁹ Cumulative retained earnings as at June 2022 are the net result of net loss as at June 2022 (US\$587 million) + accumulated deficit as at December 2021 (US\$1,520 million).

¹⁰ Income statement re-expressed for analytical purposes. Contributions to other initiatives: RPSF, AATI and PSTF.

¹¹ Does not include loans that are approved but not yet signed or ratified and have not yet met disbursement conditions.

Capital requirements by risk category

Loan portfolio valuation and credit risk

1. IFAD's Capital Adequacy Policy makes a distinction between core risks and non-core risks. The former are represented by credit risk and the loan portfolio valuation. As at June 2022, capital requirements for core risks decreased by US\$105.8 million (2.9 per cent) over December 2021. This was mainly a result of the reduction of the loan portfolio's EAD,¹² which decreased by 3.4 per cent between December 2021 and June 2022.
2. In all, core risks as a percentage of the ICA reached 47.2 per cent in December 2021. This level is fully in compliance with the target limit of 80 per cent set by the Capital Adequacy Policy.

Table 1

Capital utilization – core risks

(Millions of United States dollars and percentages)

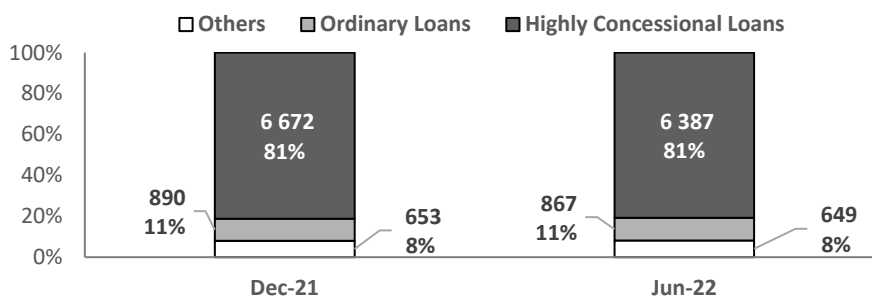
	Dec 2021	Jun 2022	2022 versus 2021	2022 versus 2021 (%)
Loan portfolio valuation	2 512.1	2 439.3	(72.8)	(2.9)
Credit risk	1 189.7	1 156.7	(33.0)	(2.8)
Total core risks	3 701.8	3 596.0	(105.8)	(2.9)
Total core risks as a percentage of ICA	47.2	47.4		0.2

3. Loan portfolio valuation is sensitive to the concessionality of lending terms and the volume of the outstanding loan portfolio. As at June 2022, the composition of the loan portfolio had marginally changed compared to December 2021. The percentage of the total outstanding portfolio consisting of highly concessional loans remained stable at 81 per cent in June 2022 in line with the proportion observed in December 2021. The capital allowance established to account for the concessionality of the portfolio decreased somewhat less than the reduction in the highly concessional outstanding loan portfolio (2.9 per cent and 4.2 per cent, respectively).

Figure 1

Outstanding loan portfolio by lending terms, December 2021 and June 2022

(Millions of United States dollars and percentages)



4. Credit risk capital utilization, on the other hand, is driven by both the volume and the quality of IFAD's EAD.¹³ As at June 2022, IFAD's EAD had decreased¹⁴ by 3.4 per cent, while its exposure-weighted average rating is gradually transitioning

¹² Calculated as outstanding loans plus undisbursed loan commitments. The undisbursed loan commitments are converted into credit exposures using a 50 per cent credit conversion factor. They do not include loans that have been approved but have not yet met disbursement conditions.

¹³ Credit risk computations are also influenced by the main credit risk parameters: probability of default and loss given default. These credit risk parameters are reviewed on a regular basis.

¹⁴ This decline is mainly attributed to the translation effect of the currency depreciation of SDR against United States dollars.

from the current B1 rating to the B2 rating as a result of the challenging economic environment. The net effect is a reduction of 2.8 per cent in the credit risk capital charges.

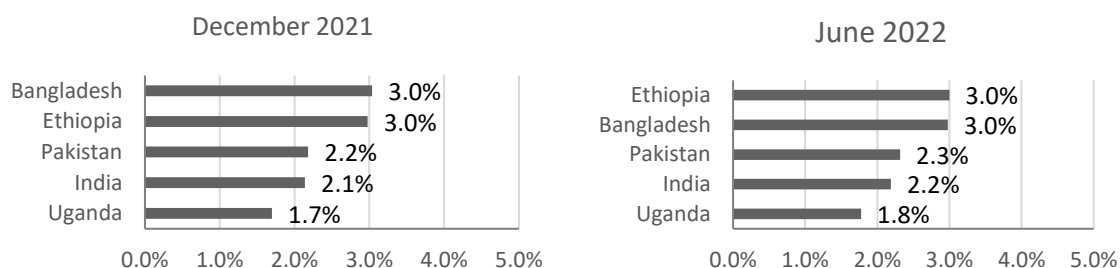
5. Within the Capital Adequacy Policy, there are two complementary approaches to monitor country credit risk and concentration risk: country exposure measured in nominal terms and country capital consumption (risk-based). In nominal terms, IFAD's largest source of country exposure as at June 2022 corresponded to China, which represented 8.3 per cent of the ICA; this was still well below the prudent limit of 20 per cent.

Figure 2

Top five countries for EAD as a percentage of the ICA

6. The contribution of each country to total capital consumption¹⁵ is a function of volume, credit rating and lending terms. The top five contributors in terms of capital consumption are shown in figure 3 below.

Figure 3

Top five countries for capital utilization as a percentage of the ICA

7. A summary of exposure, average capital charges, average ratings and capital utilization by region is provided in table 2 below.

¹⁵ The single country limit is computed in nominal terms and does not account for credit risk. Capital utilization as a percentage of the ICA is a complementary measure that incorporates credit differentiation.

Table 2

Capital utilization by region – core risks

(Millions of United States dollars and percentages)

	<i>Asia and the Pacific</i>	<i>East and Southern Africa</i>	<i>West and Central Africa</i>	<i>Near East, North Africa and Europe</i>	<i>Latin America and the Caribbean</i>	IFAD total
Outstanding loans	3 002.3	1 924.8	1 482.2	945.6	548.3	7 903.1
EAD	3 649.5	2 267.5	1 817.8	1 151.5	616.1	9 502.3
Capital allocation (loans)	1 170.5	1 044.8	790.3	423.9	169.4	3 598.8
Average capital charges (percentages)	32	46	43	37	27	38
Average rating	Ba2	B3	B3	B3	B1	B1
Percentage of highly concessional outstanding loans	77	97	95	60	42	81

8. An assessment of capital allocation by region indicates that Africa is the region with the largest proportion of highly concessional loans (not including grants), in line with IFAD's mandate. The Latin America and Caribbean region has lower average capital charges than other regions owing to the smaller proportion of highly concessional loans in its loan portfolio. The average credit rating of the Latin America and the Caribbean portfolio is higher than those of all other regions except Asia and the Pacific.

Other risks

9. According to the Capital Adequacy Policy, non-core risks include currency risk, market risk and operational risk. Relative to December 2021, total non-core risks as a percentage of the ICA had increased by 0.2 percentage points to 2.9 per cent in June 2022. This is in compliance with (and is well below) the target limit of 10 per cent.

Table 3

Capital utilization – other risks

(Millions of United States dollars and percentages)

	<i>Dec 2021</i>	<i>Jun 2022</i>	<i>2022 versus 2021</i>	<i>2022 versus 2021 (%)</i>
Currency risk	82.5	63.7	(18.9)	(22.9)
Market risk – investment portfolio	107.1	138.3	31.2	29.1
Operational risk	18.6	17.6	(1.0)	(5.6)
Total non-core risks	208.2	219.6	11.3	5.4
Total non-core risks as a percentage of the ICA	2.7	2.9	-	0.2

10. As at June 2022, capital requirements deriving from market risk in the investment portfolio had increased by 29 per cent. Overall, this capital requirement as a percentage of the ICA slightly increased from 1.4 to 1.8 per cent. This increase is mainly explained by the increase in the size of the investment portfolio.
11. Currency risk capital requirements decreased by 22.9 per cent between December 2021 and June 2022 owing mainly to a reduction in the foreign exchange gaps.
12. Operational risk is computed on the basis of an adjusted Basel basic indicator approach, according to which the capital to be held to account for operational risk must be equal to 15 per cent of the institution's average annual gross income over the past three years. However, IFAD used the maximum annual gross income over that period rather than the average. Measured in this way, the value remained relatively stable between December 2021 and June 2022.

Formulas and definitions

Ratio/heading	Formula/definition
Deployable capital	Deployable capital = $\frac{\text{initial capital available} - \text{total resources required} - \text{buffer}}{\text{initial capital available}}$
Initial capital available	Initial capital available = total equity – contributions and promissory note receivables + allowance for loan losses
Total resources required	The aggregation of capital requirements for IFAD's core and non-core risk exposures
Core risk exposures	Capital requirements for loan portfolio valuation and credit risk
Non-core risks	Capital requirements for currency risk, market risk in the investment portfolio and operational risk
Buffer	10 per cent of the ICA
Leverage	Leverage = $\frac{\text{financial liabilities}}{\text{initial capital available}}$
Core risk capital consumption	Core risks = $\frac{\text{loan portfolio credit risk} + \text{net present value}}{\text{initial capital available}}$
Non-core risk capital consumption	Non – core risks = $\frac{\text{capital requirements for other risks}}{\text{initial capital available}}$
Single country limit	Nominal country exposure = $\frac{\text{single country exposure in nominal terms}}{\text{initial capital available}}$

Glossary

Exposure at default. An estimate of the level of exposure (amount outstanding, including disbursed and potential future exposure of undisbursed loans) at the time of default.

Credit conversion factor. An estimate of the proportion of off-balance sheet exposure that would be translated into exposure at default.

Exposure-weighted average rating. An indicator that provides an overview of the credit quality of the loan portfolio. It is computed as a weighted average rating for the outstanding loan portfolio.

Risk-bearing capacity. The amount of risk a financial institution can take. It is usually determined as a function of the available capital measured against total development-related operations.

Stress test. A risk management tool used to evaluate potential adverse effects of specific exceptional but plausible events or material changes in market variables.

Value-at-risk. The maximum potential loss an investment can incur over a defined time horizon within a specified confidence level. For example, a value-at-risk over one year with a confidence level of 99 per cent that is equal to US\$1 million means that a loss over a period of one year is expected to exceed US\$1 million only 1 per cent of the time.