
Chapeau paper on capital optimization

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Action: The Executive Board is invited to review the chapeau paper on capital optimization, in which Management presents an overview and rationale for the changes being proposed to the Capital Adequacy Policy and the Integrated Borrowing Framework.

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Chapeau paper on capital optimization

I. Introduction

1. Since IFAD embarked on a financial architecture reform process in 2018, the organization has taken significant steps to strengthen its financial policy framework – including the Debt Sustainability Framework (DSF) reform, a new Capital Adequacy Policy, a revised Liquidity Policy, and an Integrated Borrowing Framework combining the legacy Sovereign Borrowing and Concessional Partner Loan Frameworks. These were all necessary steps to reinforce IFAD’s financial sustainability in the medium-to-long term, also proving beneficial throughout IFAD’s credit rating process, whereby the Fund obtained two AA+ credit ratings from Standard and Poor’s (S&P) and Fitch in 2020.
2. The successful rating process allowed IFAD to further diversify its funding sources, executing its first capital market operations under the form of private bond placements to complement Member State core contributions. IFAD’s credit ratings also allowed it to continue sourcing loans from sovereign and supranational lenders, which were critical to support IFAD’s and Member States’ programming ambitions prior to the launch of private placements.
3. With the main policies of the financial reform now in place, IFAD has now taken stock of the financial reform process. During 2024 and 2025, IFAD and Member States have engaged in various touchpoints, both formal and informal, to discuss IFAD’s opportunities for the capital optimization of existing resources, with the main goal to ensure that IFAD’s financial strategy continues to serve the business model and strategic objectives set by the Executive Board. Simply put, the overarching objective is to protect IFAD’s nature as a concessional development fund in the long term, optimizing resources to low-income countries (LICs) and lower-middle-income countries (LMICs) and maintaining its commitment to universality.
4. Over the course of this exercise, two major conclusions have been reached regarding IFAD’s current financial position: (i) the Fund enjoys an excellent capital position (as affirmed by both rating agencies over multiple years); and (ii) there is space for IFAD to optimize its capital utilization, unlocking a certain untapped potential. However, IFAD’s very conservative leverage ratio limit does not allow it to seek the optimization of its capital and more efficient use of existing Member State resources. Furthermore, focusing on leverage reflects the structure of IFAD’s liabilities and the weight of its debt, but in no way the adequacy of capacity and risk-taking.
5. Optimizing capital, however, requires a balance: if the Fund is over-capitalized, there is the risk of under-utilizing the Fund’s resources and not using Member State contributions to their fullest potential; on the other hand, consuming capital too quickly would put the viability of the organization at risk. Capital optimization will reinforce IFAD’s capacity to fulfill its mission, which is to serve the poorest rural populations in the world’s most vulnerable areas – and most importantly, to be able to do so in the long term.
6. The proposed financial policy changes enhance the way IFAD measures and monitors risk. The monitoring framework proposed as part of the revised Capital Adequacy Policy is built to reflect the Fund’s strategic choices and quantify them in the long term for Management and Member States to anticipate action when necessary.
7. However, capital optimization does not stop at updating the Capital Adequacy Policy; optimizing capital is embedded in different parts of the business, for

example in the risks taken by the institution. To continue in this direction and optimize liquidity management, IFAD is proposing to operationalize collateral management activities, as per the current Integrated Borrowing Framework, to further align to international best practices. Collateralization can reduce market and counterparty credit risk, which is now considered in the Capital Adequacy Policy. Collateralizing IFAD's derivative exposures can minimize the consumption of capital by these transactions that can instead be freed up for operations. However, this will require updating IFAD's borrowing toolkit by introducing short-term financing tools such as commercial paper.

8. Over the course of this exercise, the following key themes have emerged: preserving the organization's nature as a concessional development fund, maintaining a sustainable financial model in the long term, and understanding the risks and the trade-offs of capital optimization, while also comparing IFAD with peers. The proposals to change these two financial policies fully align with the priorities put forward by Member States.
9. With this chapeau paper on capital optimization, Management presents an overview and rationale for the changes being proposed to the Capital Adequacy Policy and the Integrated Borrowing Framework, to support Member States' review of both policies at the November meeting of the Audit Committee and the Executive Board's subsequent consideration for approval in December.

II. Revising IFAD's Capital Adequacy Policy

10. Following the approval of IFAD's first ever Capital Adequacy Policy in December 2019, IFAD has made significant strides towards the implementation of its enhanced hybrid financial business model. A revised Capital Adequacy Policy was presented for discussion to the Audit Committee at its 178th meeting and has been enriched to incorporate the feedback received from Audit Committee members.
11. The rationale for the revised policy is to drive IFAD's capital optimization objectives to unlock IFAD's development impact potential without compromising financial sustainability. This will be achieved by: (i) incorporating the required enhancements following the assessment of the policy's appropriateness since its approval; (ii) incorporating the necessary elements stemming from the ongoing discussions with credit rating agencies; and (iii) integrating, when possible, the recommendations from the assessment of the capital adequacy frameworks report commissioned by the G20. The prominent changes to the updated policy are the following:
12. **Deployable capital confirmed as the main binding limit.** Deployable capital was established as the main measure to assess IFAD's capitalization upon approval of the Capital Adequacy Policy in 2019. It captures and encompasses all the components and main decisions related to IFAD's financial and operating model, including lending and grant capacity, levels of concessionality, loan portfolio quality, market risks, preferred creditor status, etc. Deployable capital is being confirmed as the main binding limit to ensure that the policy remains benchmarked to international best practices, which call for basing commitment capacity on risk-bearing metrics. This also allows the policy to be well equipped to assess potential capital optimization strategies in the future, which can be used for enhancing the Fund's risk profile. The capital relief resulting from the potential implementation of such strategies in the future could ultimately create additional lending headroom to support IFAD's mandate. More generally, together with the suggested managerial zones (see para. 17), the focus on deployable capital provides a robust framework to underpin each operational policy choice with its hypothetical impact on IFAD's equity. This offers transparency on trade-offs and enables better informed decision-making.

13. **Refinements to the deployable capital ratio computation.** The current proposal considers some refinements in the quantitative approach used to determine IFAD's deployable capital – notably changes in the computation of the initial capital available, with contributions receivables and promissory notes now included in the initial capital available, and a portion of undisbursed Debt Sustainability Framework grants, which IFAD proposes to be deducted. In terms of capital utilization, the proposal will allow for the introduction of a more conservative approach to undisbursed concessional loans and refinements in market-risk and operational-risk measurements. In all, the proposal results in a lower deployable capital amount of approximately US\$75 million. The impact on the deployable capital ratio as of December 2024 will be minimal, presenting a 1.8 percentage point decline from 38.6 per cent to 36.8 per cent.
14. **Incorporation of additional risk exposures.** The revised policy incorporates the necessary amendments to expand its applicability to other types of exposures in line with IFAD's evolving financial strategy, including, for example, potential guarantees and the inclusion of non-sovereign operations on IFAD's balance sheet.
15. **Counterparty credit risk in derivative transactions.** Counterparty credit risk is being incorporated as a separate item in the Capital Adequacy Policy; previously the reference to counterparty credit risk was implicit and required clarification. IFAD has increased the use of derivative instruments for hedging purposes. When the previous policy was approved IFAD had limited exposure to derivatives instruments.
16. **Removal of the leverage ratio limit.** The Capital Adequacy Policy developed in 2019 kept the existing leverage ratio limit as a complementary non-risk-based metric. However, in practice, given its level of conservatism, IFAD's leverage limit became the main binding limit affecting future onlending capacity. Unlike deployable capital, the leverage limit is not risk sensitive; it is unable to assess the pertinence of the risk embedded within IFAD's business model (i.e. IFAD's assets) and is inconsequential to potential future capital optimization strategies, limiting the effectiveness of IFAD's capital management. The independent assessment of capital adequacy frameworks commissioned by the G20 called for a revision of the pertinence of non-risk-based statutory lending limits. Rating agencies like Fitch also emphasized, in the most recent rating criteria update, the importance of risk-sensitive capital ratios (in the case of Fitch, the usable capital to risk-weighted assets ratio, known as the FRA), making it the main anchor of the capitalization assessment for multilateral lending institutions. The revised Capital Adequacy Policy proposes to remove the leverage limit from the policy to ensure deployable capital remains the main measure to assess IFAD's capitalization. IFAD will continue maintaining a prudent approach to leverage and future programming capacity, determined by internal (deployable capital) and external (credit rating agencies) capital ratios, complemented by newly developed managerial thresholds. This is why IFAD will keep monitoring its capital and leverage ratios carefully.
17. **Introduction of managerial thresholds, capital optimization plan and capital preservation plan.** The revised Capital Adequacy Policy proposes strengthening IFAD's capital management process by determining managerial zones for IFAD's deployable capital and applicable rating agency capital ratios to ensure that capital availability remains sustainable in the long term, even in times of stress. This best practice is successfully applied in some peer international financial institutions (IFIs) and will address the recommendation made by the Office of Audit and Oversight of adding additional thresholds to the policy limit to allow for mitigating actions sufficiently in advance. These zones, along with a newly developed continuous capital optimization plan and capital preservation plan, are meant to provide the visibility IFAD needs to safeguard and strengthen IFAD's financial capacity in the long term. IFAD Management will proactively optimize utilization of IFAD's capital base in accordance with the governance process

pertaining the managerial zones thresholds as outlined in the Capital Adequacy Policy.

18. **Stress test framework.** The stress test was mainly focused on a single factor sensitivity analysis and shocks in isolation. This process is being enriched by including scenario analysis, references to environmental, social and governance (ESG) factors and reverse stress tests.¹
19. **Editorial enhancements to better clarify the content of the document.** The updated policy removed the reference to several balance sheet items and figures at a specific date that had become outdated. Avoiding references to specific figures will ensure the policy's consistency and stability over time. The revised policy also incorporates changes in the governance and responsibilities section in line with IFAD's evolving governance structure.

III. Revising the Integrated Borrowing Framework

20. The revisions to the Integrated Borrowing Framework align with IFAD's capital optimization strategy and the rationale to unlock IFAD's development impact potential without compromising financial sustainability. This also reflects the Fund's enhanced expertise and the growing complexity of its financial operations and product offering. The proposal to change the name of the document from "Integrated Borrowing Framework" to "IFAD's Borrowing Framework" reflects the evolution and maturity of the Fund's policies. Since earlier frameworks (such as the sovereign borrowing and concessional partner loan frameworks) were consolidated in 2021, the reference to "integrated" is now outdated. The recommended name change better aligns with the current, self-contained policy, which stands as IFAD's primary guidance for its borrowing activities.

Liquidity management – Pillar A. Eligible lenders and Pillar B. Borrowing instruments

21. The set of changes introduces the essential tools required to fulfil objective 2 of the current Integrated Borrowing Framework: efficient liquidity management.
22. To further implement and fulfil this objective, it is necessary to introduce short-term liquidity providers as eligible lenders and to permit the use of liquidity management instruments as permitted borrowing instruments.
23. This will enable IFAD to issue commercial paper, as well as enter into repurchase agreements, both widely used among peers as tools for liquidity management in treasury operations. Since these instruments are intended to meet cash requirements arising from IFAD's short-term liquidity management needs, rather than to finance a pre-defined programme level such as the programme of loans and grants in the medium and long term, IFAD's Borrowing Framework will explicitly exclude such amounts from the annual funding plan. Consistent with the flexible application and the overall nature of these instruments, it is not operationally practical to secure prior approval for individual transactions or investors.
24. In conjunction with these proposed amendments, a draft Governing Council resolution is provided in annex I of IFAD's Borrowing Framework. The aim of the resolution is to distinguish between the public issuance of debt for financing projects and programmes, whose commencement remains under the purview of the Governing Council, and borrowing to effectively mitigate risks in liquidity management, which naturally should not fall under the same governance. This resolution would amend GC 44/Resolution 223 XLIV, which predates the introduction of the goal of efficient liquidity management in the revised Integrated Borrowing Framework approved in 2023, and therefore did not take it into

¹ Reverse stress testing refers to a process whereby IFAD will explore extreme scenarios leading to severe negative outcomes for the Fund, and determine potential events or conditions that could lead to that result.

consideration. The amendments to IFAD's Integrated Borrowing Framework will come into effect upon the approval of this resolution by the Governing Council.

Product offering - Pillar C. Use of borrowed funds

25. The set of proposed changes, whereby the term "loans" is replaced with the broader concept of "operations" and "programmes and projects", reflects IFAD's ambitions to diversify its product offering to better serve the needs of its clients – for example, anticipating the inclusion of partial credit guarantees if the new instrument is adopted by Member States in the future.
26. In consideration of and in coherence with the amendments to the Capital Adequacy Policy, whereby capital indicators will be actively projected and monitored, the paragraph on financial sustainability is a duplication of concepts, and therefore redundant.

Borrowing thresholds – Pillar D. Borrowing governance

27. Following the amendments to the Capital Adequacy Policy discussed in section II, the references to maximum borrowing thresholds established in the Capital Adequacy Policy will be deleted. As per current practice, funding plans will continue to be established in line with the needs of ongoing operations and target levels of future programming, which is assessed based on long-term capital availability on a cycle-by-cycle basis, and validated annually through the resources available for commitment document approved by the Executive Board.

Table 1

Proposed changes to the 2023 Integrated Borrowing Framework and rationale by pillar

<i>Pillar</i>	<i>Change</i>	<i>Rationale</i>
Title	Change from Integrated Borrowing Framework to IFAD Borrowing Framework	To align with the current, self-contained policy, which stands as IFAD's primary guidance for its borrowing activities.
A. Eligible lenders	Inclusion of short-term liquidity providers	Enhancement of financial sophistication, risk management and cost reduction
B. Borrowing instruments	Inclusion of commercial paper	Enhancement of financial sophistication, risk management and cost reduction
C. Use of borrowed funds	Replacement of the term "loans" with the broader concept of "operations" and "programmes and projects"	Consistency across corporate initiatives in line with IFAD's ambitions to diversify its product offering to better serve the needs of its clients (e.g. possibility to use borrowed funds for potential pay-outs under partial credit guarantees if they are adopted by Member States)
	Deletion of paragraph on financial sustainability	The paragraph is now redundant considering that financial sustainability is embedded in capital indicators projections and monitoring.
D. Borrowing governance	Deletion of references to maximum borrowing thresholds	Consistency across financial policies following the amendments to the Capital Adequacy Policy
E. Risk management	No change	

IV. Conclusion

28. In sum, the overarching objective of capital optimization is to protect IFAD's nature as a concessional development fund in the long term, optimizing resources to LICs and LMICs and maintaining its commitment to universality. These policy updates aim to optimize the Fund's lending capacity while ensuring that solvency levels remain a strength in support of IFAD's AA+ credit rating.

29. Capital optimization is a journey, consisting of steps that will enable IFAD to enhance its impact for rural populations. It is not merely a financial discussion, but rather a tool to ensure that the Executive Board's strategy is financed in the most effective manner, while ensuring the long-term financial sustainability and viability of the Fund, even in times of stress.
30. This chapeau paper on capital optimization is accompanied by the revised Capital Adequacy Policy and Integrated Borrowing Framework, which are both being submitted to the Executive Board for approval at its 146th session.