Investing in rural people

Executive Board
146th Session
Rome, 9–10 December 2025

Revised Capital Adequacy Policy

Document: EB 2025/146/R.23

Agenda: 8(b)(ii)

Date: 12 November 2025

Distribution: Restricted

Original: English

FOR: APPROVAL

Useful references: Capital Adequacy Policy (EB 2019/128/R.43)

Action: The Executive Board is invited to approve the proposed policy update.

Technical questions:

Roger Fischer
Director and Chief Risk Officer
Office of Enterprise Risk Management
e-mail: r.fischer@ifad.org

Jose Joaquin Morte Molina
Director and Deputy Chief Risk Officer
Office of Enterprise Risk Management
e-mail: j.mortemolina@ifad.org

Contents

Annexes

Executive summary

1. Since the approval of its first-ever Capital Adequacy Policy (CAP) in December 2019, IFAD has made great strides towards implementation of its enhanced financial business model. In this regard, IFAD’s Office of Enterprise Risk Management has conducted a comprehensive review of IFAD’s Capital Adequacy Policy. The rationale for the policy review is threefold: (i) to incorporate the required enhancements following the assessment of the policy’s appropriateness since its approval; (ii) to incorporate the necessary elements stemming from the ongoing discussions with credit rating agencies (CRAs); and (iii) to integrate, when possible, the recommendations from the assessment of the Capital Adequacy Frameworks report commissioned by the G20.

2. The CAP update considers IFAD’s nature as a hybrid concessional fund and aims to support IFAD’s mandate while ensuring that solvency levels remain a strength supporting IFAD’s AA+ credit rating. Following a thoughtful review of the evolution and projection of existing capitalization ratios and leverage, it is proposed that the deployable capital (DC) ratio be used as the main ratio for measuring IFAD's current and forward-looking capital positions while serving to assess its leverage capacity (the maximum amount IFAD can borrow to finance its assets).

A. Background and approach

3. The CAP establishes principles for determining the amount of capital required to maintain the institution's equity position and optimize the use of core contributions, thereby ensuring the continuity of IFAD's development operations, even in times of stress. The policy is grounded in the best practices of multilateral lending institutions and has been adapted to IFAD's particular niche. It constitutes a key pillar for the determination of the Fund's risk-bearing capacity during each replenishment consultation.

4. The policy defines a process for determining a capital adequacy ratio, or the availability of capital, for use in assessing IFAD's current and forward-looking capital positions, together with an exposure management framework, a comprehensive stress-test exercise and a capital planning process.

5. The importance of capital adequacy derives from the composition of IFAD’s balance sheet. IFAD offers loans to different countries on different financial terms, with different maturities and currencies. The risk associated with the composition of IFAD’s balance sheet and off-balance sheet commitments needs to be supported by capital.

6. IFAD's Capital Adequacy Policy is the foundation that supports the risks embedded in its assets, enabling the institution to efficiently manage its capital and prudently leverage its balance sheet. Management of the capital base ultimately provides a predictable and stable tool for determining the level of operations to which IFAD can commit in each replenishment cycle as it transitions from a purely long-term liquidity approach to a solvency and liquidity approach.

7. To that end, the DC ratio is proposed as the main ratio for measuring IFAD's current and forward-looking capital positions; this ratio would thus be confirmed as a key component of the strategic and financial planning process. The DC ratio is also essential for assessing leverage capacity (the maximum amount IFAD can borrow to finance its assets), while ensuring that IFAD’s capital position is consistent with CRA requirements for a sound credit rating.

B. Rationale for updating IFAD’s Capital Adequacy Policy

8. Since the approval of its first-ever Capital Adequacy Policy in December 2019, IFAD has made great strides towards implementation of its enhanced financial business model. During this time period, IFAD also exhibited a robust track record in adhering to CRA methodologies. In this regard, IFAD’s Office of Enterprise Risk

Management has conducted a comprehensive review of IFAD's Capital Adequacy Policy, based on the results monitored since the policy's approval, with specific emphasis on IFAD's evolving balance sheet, asset characteristics and risk profile. This policy review also considers the assessment by the Capital Adequacy Frameworks report commissioned by the G20, enhancements in the stress-test framework and changes in the current organizational and governance structure.

9. Independent external and internal bodies have conducted various assessments, which have concluded that the current Capital Adequacy Policy is fit for purpose and covers all main relevant risk measurements that would facilitate informed decision-making. Nonetheless, these assessments have identified some areas for improvement, which are proposed in this policy review.

10. IFAD's Capital Adequacy Policy update considers:

    (a) The assessment of the historical results monitored since the policy's approval, including the evolution of IFAD's capital ratios and leverage under its hybrid business model.

    (b) The evolution of IFAD's financial and risk policies.

    (c) The track record in monitoring key CRA solvency metrics.

    (d) The inclusion of private sector operations on IFAD's main balance sheet.

    (e) The enhancement of the stress-test framework.

    (f) Changes in the current organizational and governance structure.

    (g) The recommendations from independent external reviews and the internal audit performed by the Office of Audit and Oversight.

    (h) The assessment in the Capital Adequacy Frameworks report commissioned by the G20.

    (i) The need to enrich the policy to assess innovative balance sheet optimization measures.

11. The prominent strategic items derived from the above are the removal of the leverage ceiling from the CAP and the confirmation of DC ratio as the main binding policy limit, the incorporation of new credit risk exposures (e.g. non-sovereign operations) on IFAD's balance sheet, refinements to DC ratio computation and the enhancement of IFAD's capital planning approach and stress-test framework.

12. The CAP strengthens its capital management process by determining instauration of managerial zones for the DC ratio and CRA capital adequacy ratios to ensure that capital availability remains sustainable, even in times of stress. These zones, along with applicable capital management measures, are geared to strengthening IFAD's financial capacity in the long-term.

13. Ultimately, IFAD aims to maximize its development impact through more efficient use of its existing capital (through long-term capital planning) and a more fit-for-purpose leverage strategy.

14. The current proposal considers some refinements in the quantitative approach used to determine IFAD's DC – notably changes on the computation of the initial capital available (ICA), with contributions receivables and promissory notes, now included in the ICA, and a portion of undisbursed Debt Sustainability Framework grants, proposed 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 DC amount by approximately US$75 million. The impact on the DC ratio as of December 2024 would be minimal, presenting a 1.8 percentage point decline from 38.6 to 36.8 per cent.

Revised Capital Adequacy Policy

I. Objectives

1. The purpose of the Capital Adequacy Policy is to establish principles for determining the amount of capital required to maintain the institution's equity position and to optimize the use of ~~donors'~~ core contributions, thereby ensuring the continuity of IFAD's development operations, even in times of stress, as it works to further an inclusive and sustainable rural transformation process.

2. IFAD's ~~proposed~~ Capital Adequacy Policy has two dimensions: (i) it will serve as a risk management tool that can be used to quantify financial capacity to limit losses, plan operations and create value by optimizing capital allocation; and (ii) it will also serve as an indication of IFAD's capitalization (and solvency) to any external stakeholder, including lenders, external auditors and rating agencies.

3. Capital levels will be determined in relation to the level of risk inherent in IFAD operations and the desired solvency level[1] as established in the ~~risk appetite statement~~Risk Appetite Statement (RAS), ensuring that IFAD's capitalization remains a strength supporting IFAD's strong credit rating, even in times of stress.

4. The principles presented in this document will facilitate the following key activities:

   (a) Allocation of the use of capital across different types of exposure;

   (b) Financial planning and the alignment of asset growth with the available level of equity;

   (c) Alignment with capital adequacy requirements and standards set by ~~regulatory bodies and~~ credit rating agencies~~, and~~ and industry best practices, ensuring maintenance of the desired credit profile, even in times of stress; and

   (d) Provision of support for decision-making at the transaction level.

II. Risk exposure and methodology

5. The ~~proposed~~ Capital Adequacy Policy provides for the identification, quantification and monitoring of relevant risks with the aim of ensuring that IFAD maintains its desired level of solvency. This will be accomplished by comparing the available level of own resources (capital) against the quantification of the identified material risks and ensuring that the Fund holds sufficient capital to absorb losses in the event that they materialize.

6. The methodologies for determining capital utilization for the different types of risks are detailed below.

A. Net present value of the loan portfolio

7. The incorporation of the loan valuation effect in capital adequacy metrics is IFAD-specific considering ~~the nature of its operations. In line with IFAD's mandate, its loans are granted predominantly on concessional terms, with nearly 86 per cent[2] of the portfolio composed of highly concessional loans (below-market interest rates).~~its nature as a hybrid concessional fund. This results in implicit economic losses in the nominal loan portfolio when valuing it in present value terms and applying market rates.

8. IFAD's capital allowance to account for loan portfolio valuation losses will be assessed as follows:

[1] ~~Usually expressed as a credit rating.~~
[2] ~~As at December 2018.~~

(a) The difference between the nominal value and the present value of the aggregate concessional loan portfolio will need to be computed to arrive at a net present value (NPV);

(b) In order to provide stability to the deployable capital ratio, loan portfolio NPV will be determined utilizing a stressed interest rate to account for potential increases in market interest rates that could affect IFAD's capital requirements; and

(c) The aforementioned computation will exclude ordinary loan operations.

B. Credit risk

9. Credit risk, generally, is defined as the risk of loss stemming from failures to meet an obligation owed to IFAD. In particular, it is defined as the risk that such losses could arise as a result of ~~a borrower's~~an obligor's default or its credit- rating downgrade. ~~This usually includes issuer, counterparty, settlement, default and country risk. In the case of IFAD, both loan book and investment portfolio exposures are subject to credit risk.~~

~~1. For capital adequacy purposes, the loan book corresponds to the loan operations on the balance sheet and the undisbursed portion of approved loan operations. Given its mandate, IFAD's loan book is concentrated in countries with an exposure-weighted average equivalent rating of B+/B1.[3] Despite its credit risk profile, the performance of the portfolio has historically been satisfactory, largely reflecting the preferred credit treatment (PCT) that IFAD enjoys.~~

~~2. IFAD's investment portfolio has an average weighted rating of A.[4] The portfolio has a short duration position (average maturity of discounted cash flows) of approximately one year and thus exhibits a high liquidity profile.~~

10. Capital adequacy requirements for credit risk entail utilization of the following ~~general~~main parameters[1] to compute capital consumption for each exposure: exposure at default (EAD), probability of default (PD), loss given default (LGD), ~~maturity, time horizon and confidence level. The assumptions used to determine each risk parameter vary according to the approach selected to compute capital requirements (economic capital, regulatory capital or credit rating agencies' methodologies). Definitions of these parameters are provided in annex I.~~time horizon and confidence level.

11. All exposures derived from IFAD's development-related operations (e.g. loan portfolio, guarantees and equity investments) are subject to capital requirements. For capital adequacy purposes, credit exposure corresponds to the outstanding sovereign and non-sovereign loans on the balance sheet, the undisbursed portion of approved sovereign and non-sovereign loan commitments, and sovereign and non-sovereign guarantees.

12. IFAD ~~borrowers'~~obligors' credit ratings are a fundamental component of the computation of capital charges. ~~Within the framework of the recent implementation of the International Financial Reporting Standard 9 impairment requirements based on an expected credit loss model, the Fund~~The Fund has established an internal credit rating methodology that lends greater visibility to ~~borrowers'~~obligors' credit risk. This allows for mapping each rating with specific risk parameters (PD and LGD) and therefore computing the corresponding risk charges.

13. Given the Fund's mandate, IFAD's loan portfolio is concentrated in countries with an exposure-weighted average equivalent rating below investment grade. Despite its credit risk profile, the performance of the sovereign loan portfolio has historically

~~[3] As at December 2018.~~
~~[4] As at December 2018.~~
[1] Definitions of these parameters are provided in annex I.

been satisfactory, largely reflecting IFAD's preferred credit status (PCS). PCS is embedded in the computation of IFAD's PDs and LGDs.

14. IFAD's capital requirements for credit risk will be assessed as follows:

    (a) The economic capital needed for unexpected losses from credit risk will be considered at a confidence level and for a holding period consistent with the desired solvency level[5] as established in IFAD's RAS;

    (b) All credit exposure (EAD) in the sovereign and ~~-~~non-sovereign loan ~~book and the investment~~ portfolio will be considered;

    (c) ~~Outstanding loans~~Loan EADs, except for ~~loans~~those on ordinary terms, will be considered at NPV;

    (d) All undisbursed loan commitments will be included by applying a specific credit conversion factor; ~~and~~

    (e) All guarantee exposures will be recognized as a loan-equivalent exposure by applying a specific credit conversion factor, and capital requirements will follow the approach applicable to the loan portfolio; and

    (f) Expected losses will be added to the figure for unexpected losses to compute the overall amount of capital required to cover credit risk.

~~3. Additionally, support measures to reassess IFAD's capitalization based on regulatory measures (Basel Accords) and compliance with rating agencies' capital adequacy standards will be computed for supplementary judgement, benchmarking and monitoring purposes (see annex IV).~~

C. Equity investments

15. Equity investments are part of IFAD's operations and will be considered as a full deduction of capital.

D. Interest rate risk in the loan portfolio

16. Interest rate risk is defined as the potential risk that the value of a fixed-rate asset will decline as a result of changes in interest rates. As concessional loans are typically long-dated fixed-rate loans ~~account for 88 per cent of the loan portfolio~~, IFAD's loan valuation is exposed to movements in market interest rates. Any change in these variables will have an impact on the economic valuation of the loan portfolio.

17. Considering that IFAD's NPV will be assessed utilizing a stressed interest rate, no additional capital allocation will be applied in respect of interest rate risk in the loan portfolio. However, the loan portfolio interest rate risk[6] will be monitored to guarantee that the stressed interest rate utilized to compute the NPV of the loan portfolio is consistent with prevailing market conditions.

E. Currency risk

18. Currency risk arises from the potential for losses stemming from changes in foreign exchange rates. IFAD's equity is exposed to foreign exchange or currency risk to the extent that assets and liabilities are denominated in different currencies.

~~4. IFAD's outstanding loan portfolio is predominantly (98 per cent) denominated in special drawing rights (SDRs). However, the increase in approved loans under the single currency lending facility since 2016, especially loans denominated in United States dollars, is changing the currency composition of commitments and, together with new borrowing facilities, brings a new dynamic to currency risk management.~~

[5] ~~Usually expressed as a credit rating.~~
[6] ~~Credit spread risk will be also monitored.~~

~~Only 60 per cent of IFAD's undisbursed loan portfolio[7] is denominated in SDRs, while the remaining 40 per cent is denominated in United States dollars (23 per cent) or euros (17 per cent).~~

19. IFAD's capital requirements to account for currency risk will be assessed as follows:

    (a) The net position of assets and liabilities in each currency will be considered, together with a historical simulation of the behaviour of each foreign exchange rate; and

    (b) The economic capital needed to account for currency risk will be computed at a confidence level and holding period consistent with the desired solvency level.

F. Market risk in the investment portfolio

20. Market risk arises from the potential for losses in the investment portfolio owing to movements in market variables.

21. IFAD's capital requirements to account for market risk in the investment portfolio will be ~~assessed as follows:~~determined by the risk tolerance levels approved for that portfolio in the Investment Policy Statement.

    ~~(i) The economic capital needed to account for unexpected losses in the investment portfolio as a result of market risk will be determined at a confidence level and for a holding period consistent with the desired solvency level; and~~

G. Counterparty credit risk in derivative transactions

22. Counterparty credit risk in derivative transactions is the potential for loss due to credit rating downgrade of the derivative counterparty or its securities or its failure to perform obligations towards IFAD. IFAD uses derivative instruments for hedging purposes, mainly to hedge interest rate and currency risk on its balance sheet.

23. IFAD's ~~Economic~~ capital requirements to account for counterparty risk in derivative transactions will be derived from ~~the higher of two value-at-risk computations: current and stressed conditions. In addition to the above-mentioned computation, support measures will be computed to evaluate consistency with~~ Basel regulatory ~~measures (Basel Accords) and for benchmarking purposes.~~ standards.

H. Operational risk

24. Operational risk is defined as the risk of losses resulting from flawed or failed internal processes, issues with individuals or systems, or external events.

25. IFAD's capital requirements to account for operational risk will be ~~assessed as follows:~~derived from Basel regulatory standards, which can be adjusted to account for the concessional nature of IFAD's business model, if deemed appropriate.

    ~~(i) IFAD will rely on the Basel basic indicator approach, whereby the capital to be held to account for operational risk is to be equal to 15 per cent of the institution's average annual gross income over the past three years; and~~

    ~~(ii) The indicator will however be adjusted to account for the maximum annual gross income for the past three years as a conservative approach.~~

I. Aggregation of capital requirements

26. The aggregation of capital requirements for each individual risk type by adding up each capital requirement assumes that all risks are perfectly correlated, implying that potential losses for each risk would happen at the same time. The assumption

~~[7] This does not include loans that have been approved but not yet signed, loans that have been signed but not yet ratified or loans that have been ratified but have not yet entered into force, since they do not yet represent any exposure for IFAD.~~

of perfectly correlated risks is a common practice applied by financial institutions, given the difficulty of measuring correlations among risk factors.

27. For the purposes of this policy, the aggregation of capital requirements could be adjusted considering correlation among risk categories, based on specific analysis and industry benchmarking exercises performed by Management if deemed appropriate.

III. Deployable capital

28. Deployable capital (DC) is proposed as the main measure to assess IFAD's capital utilization and the availability of resources to support future commitments. The components of DC are:

    (a) **Total initial capital available (ICA).** Total equity[8] ~~– contributions and promissory notes receivable +~~[2] plus allowance for ~~loan~~expected credit losses~~;~~ minus undisbursed grants to countries in debt distress;[3]

    (b) **Total resources required (TRR).** The aggregation of capital requirements for IFAD's risk exposure (valuation adjustment, credit risk, equity investments, counterparty credit risk for derivatives, currency risk, market risk in the investment portfolio and operational risk); and

    (c) **Buffer.** A prudent buffer[4] as a percentage of the ICA will be maintained to overcome any sustained unexpected stress event ~~or countercyclical role~~ not captured by economic capital measures, or exhaustion of capital. ~~Stress test exercises will be used periodically to determine the optimal size of the capital buffer.~~

29. The projected DC is obtained by deducting the TRR and the buffer from the ICA. The DC as a percentage of the ICA corresponds to the DC ratio and is required to be above 0 per cent. Given its components, any increase in the ICA will improve the ratio, while any increase in the TRR will represent a decrease in the ratio.

30. The ICA is the main constrained resource for IFAD. Given the fact that IFAD works primarily with concessional loans and grants, its capacity to generate internal capital is limited, and the principle of capital preservation (minimization of losses) must thus be a key element of its financial strategy, along with the continuous injection of fresh capital contributions from members.

31. DC is a key component of the strategic and financial planning process. Projected DC ratio will be the cornerstone for determining IFAD's risk-bearing capacity during each replenishment consultation in order to guarantee long-term financial sustainability.

IV. Exposure management framework

32. As stated in section III, the main measure to assess IFAD's capitalization will be DC ratio, which constitutes a strategic ~~ratio~~ and ~~hard~~policy limit defined as the remaining capital available to support future commitments over and above IFAD's current risk exposures.

33. This strategic limit will be embedded in IFAD's proposed exposure management framework, which will constitute a key pillar to support capital utilization and will ~~give Management~~provide a more detailed view of IFAD's capital consumption.

~~[8] Contributions + general reserves – accumulated deficit.~~

[2] Contributions + general reserves – accumulated deficit. Other forms of capital, such as hybrid capital instruments, can be considered in the computation of the ICA to the extent that the instrument has the loss-absorbing features considered acceptable in the view of credit rating agencies or equivalent methodologies.

[3] Applying a specific conversion factor.

[4] The capital included in the buffer is to remain unallocated over planning periods to ensure it is used only in cases as described above.

34. An exposure management framework consists of three categories of limits: (i) strategic ~~limits~~limit or ~~hard limits~~policy limit; (ii) ~~target~~risk type limits; and (iii) ~~prudential limits~~ concentration limit.

(i) ~~**Strategic limits or hard limits** will ensure~~**The strategic (or policy) limit** is the DC ratio. This limit ensures that IFAD's willingness to assume risks is in line with its long-term risk-bearing capacity.

Deployable capital limit – the DC ~~as a percentage of the ICA~~ratio is required to be above 0 per cent. This means that IFAD's capital supports all capital requirements for risk exposure plus the buffer.

- ~~The buffer provided for in this policy allows the DC ratio to temporarily reach values below 0 per cent limit,[9] due to unexpected stressed events or exhaustion of capital, while still supporting capital requirements derived from IFAD's risk exposures.~~

(ii) ~~**Target**~~**Risk type limits.** A distinction will be made between core risks (credit risk ~~and~~in operations, loan portfolio valuation[~~10~~,5] and equity investment risks) and non-core risks (counterparty credit risk in derivative transactions, investment portfolio ~~credit and~~ market risk, currency risk and operational risks). The objective of these limits is to minimize the amount of capital dedicated to non-core risks.

- ~~Leverage ratio – this is considered a complementary metric to monitor the capital adequacy of any entity. This widely used measure indicates the financing of IFAD through debt. The proposed target limit is financial liabilities (i.e. outstanding amount of borrowing operations) divided by IFAD's ICA. This ratio will be required to remain within a tolerance range in tune with the evolution of contributions and capital stock.~~
- ~~Buffer – the capital included in the buffer is to remain unallocated over the planning periods to ensure it is used only in cases as described above.~~

(iii) ~~**Prudential limits.** These limits~~**Concentration limit.** This limit will assist in monitoring portfolio composition to ensure an acceptable level of concentration risk derived from the Fund's operations and to pursue a suitable degree of exposure diversification.

~~5. The limits will be approved by the Executive Board. Conservative thresholds will be set to enable preventive action to be taken before the limits are breached.~~

35. Any limit breach will be reported by the Financial Risk Management Unit to the ~~Investment and Finance Advisory~~ Financial Risk Management Committee ~~(FISCO)[11] and will be~~ , escalated to the Enterprise Risk Management Committee and reported to the Audit Committee and the Executive Board in a timely manner. ~~The relevant area responsible for managing the limit~~Management will report the cause of the breach and ~~a proposed~~propose an action plan to return to the desired level.

36. The proposed limits ~~for~~of the exposure management framework are detailed in annex III. ~~Together with all metrics included in this policy, these limits will be closely monitored for an "observation period" of 6 to 12 months after approval in order to prudently assess their impact on IFAD operations.~~

~~11. The proposed exposure framework should be reviewed in light of changes in the business strategy. For example, the introduction of new types of operations or~~

~~[9] Up to the amount of the established buffer.~~
~~[10] Loan portfolio valuation at market rates is considered a core risk due to the concessional nature of IFAD. It also includes interest rate risk in the loan portfolio.~~
[5] Loan portfolio valuation at market rates is considered a core risk due to the concessional nature of IFAD. It also includes interest rate risk in the loan portfolio.
~~[11] Reporting will be to the Finance and Risk Management Committee, once it has been established.~~

~~products derived from initiatives such as IFAD's Private Sector Engagement Strategy 2019-2024 would require the recalibration of exposure limits going forward.~~

V. Capital planning and managerial zones

37. Capital planning is of key importance in ensuring that IFAD's equity position is aligned with its embedded risk exposure over a long-term horizon. The capital planning process will be integrated with the strategic planning process during each replenishment cycle, in order to align the development objectives envisioned in the programme of loans and grants and mix of operations with the long-term financial sustainability of the institution.

38. The main objective of the capital planning process is to ensure the continuity of the Fund's operations so that it can fulfil its mandate over the long term.

39. The projected level of deployable capital, in alignment with the desired solvency level as stated in the RAS, will be the cornerstone for determining IFAD's risk-bearing capacity and leverage levels during each replenishment consultation.

40. **Managerial zones.** Conservative managerial zones will be established to monitor the evolution of the DC ratio and the trajectory of capital adequacy ratios managed by credit rating agencies (CRAs) (CRA ratios). For this purpose, each managerial zone shall have the respective thresholds for DC ratio and CRA ratios, which will be set to ensure that capital availability remains sustainable, even in times of stress;[6] at the same time, managerial zones will enable stability and transparency of capital planning over the long term. These managerial zones will be defined as follows:

    (a) The first managerial zone includes a **comfort zone,** which will comprise the range of the projected evolution of the DC ratio and/or CRA ratios, where strategic directions can be adopted under the baseline capital planning under normal conditions. This zone will provide the necessary tool for projecting DC ratio and/or CRA ratios for each replenishment cycle, coupled with the projected long-term evolution of the capital base and its utilization.

    (b) **Preservation zone.** This zone implies a situation where DC ratio and CRA ratios are close to the internal limit for DC ratio and/or external CRA ratios' thresholds, monitored by CRAs, with the risk of potentially breaching the limit or thresholds.

41. These zones are in addition to the **prudential buffer** of 10 per cent, which is devoted mainly to absorbing unexpected capital requirements stemming from stress events; therefore, a DC ratio above the 0 per cent policy limit enables preventive action to be taken before the limit is breached and utilization of the 10 per cent is required.

42. Management shall determine the minimum threshold for the preservation zone and may introduce updates to this threshold when deemed appropriate. Management shall inform the Audit Committee and the Executive Board of the minimum threshold for the preservation zone and any changes proposed for these parameters.

43. Management shall implement actions in consultation with the Executive Board to maintain the desired capital levels, following the guidelines provided in annex IV.

44. The Financial Risk Management Unit shall regularly report compliance with the managerial thresholds to the corresponding Management committees and governing bodies through the capital adequacy report.

[6] These zones follow prudential regulatory principles, whereby different layers of capital transparently and efficiently support capital planning.

VI. Stress test

45. ~~Capital adequacy will also be assessed under a comprehensive stress test exercise in order to identify~~The stress-testing framework involves a thorough evaluation of capital adequacy aimed at identifying particular vulnerabilities that could affect IFAD's capital position. This exercise ~~will be undertaken~~is conducted periodically ~~in order to assess the size of the capital buffer,~~ to identify potential weaknesses in the capital measures and ~~exposure framework and to~~ provide insights into how specific extraordinary ~~but~~, yet plausible, events could affect the ~~capital ratios.~~DC ratio, in line with IFAD's Risk Appetite Statement and IFAD's mandate. Given the focus on reducing poverty and food insecurity in rural areas through agriculture and rural development, environmental, social and governance factors are an integral part of the stress-testing framework.

~~6. The stress test exercise will include events that would influence all major types of risks, in order to identify measures that the institution can take to reduce its risk exposure.~~

46. IFAD identifies all types of material risks affecting its business that are related to both on- and off-balance sheet exposure. Material risks will be stressed according to a well-defined stress-testing methodology and scenario selection.

47. The specific design, complexity and level of detail of the stress-test methodologies are appropriate to IFAD's nature, scale and size, as well as the complexity and riskiness of its business activities, and take the strategy, business model and portfolio characteristics into account.

48. Calibration of the sensitivity of the scenarios will be based on the current economic cycle and expressed in terms of macroeconomic and financial variables and specific vulnerabilities based on IFAD's characteristics. These scenarios will also be of help in assessing IFAD's ability to survive prolonged and severe shocks while maintaining its ability to deliver country programmes and projects.

49. The stress-test exercise will be conducted as follows:

    (a) **Frequency.** At least once a year, in order to monitor how changes in the environment or IFAD's strategy might impact the prevailing capital measures and to determine whether those measures remain appropriate.

    (b) **Type of stress tests.** ~~The main type of~~IFAD performs stress ~~testing will be solvency~~ tests based ~~single factor~~on sensitivity ~~analysis. This~~analyses, scenario analyses and reverse stress testing.

        (i) Sensitivity analyses are conducted for individual portfolios, identifying the relevant risk factors; in this case, this means that the stress test will assess the impact of a large shock in one factor in isolation on IFAD's capital position. ~~These scenarios could be complemented by multifactor historical scenarios allowing the application of shocks to many parameters simultaneously.~~

        (ii) ~~**Scenarios.**~~Scenario analysis constitutes the core feature of the stress-test framework, allowing for a comprehensive assessment of the Fund's risk. The results obtained from single risk-factor analysis should be used to identify scenarios that include stress of a combined set of plausible risk factors (i.e. multi-risk-factor analyses). The stress-test tools in use ensure that stressed risk factors translate into internally consistent parameters.

        (iii) Reverse stress testing is used to increase IFAD's awareness of current and potential vulnerabilities and to understand the viability and sustainability of its business model and strategies. Reverse stress testing starts with a pre-defined outcome (e.g. in terms of low solvency

ratios) to produce the worst possible scenarios to which IFAD is particularly exposed.

(c) **Risk methodologies.** The main stress-test analysis will include but not be limited to changes in the following ~~single factor scenarios~~risk areas, in both isolation and scenario analyses:

- Potential downgrade scenarios for IFAD's major ~~borrowers and the~~ obligors with effect on IFAD's entire ~~loan portfolio.~~credit exposure;
- The marginal impact of other emerging risks;
- Application of severe shocks to market variables (interest rates and currency exchange rates);
- Accelerated asset growth;
- Accelerated growth in grants operations; and
- Reverse stress test to explore scenarios that could potentially lead IFAD to fail and make its financial hybrid business model unviable.

(d) **Outcomes.** ~~The following are examples of~~IFAD should ensure it has enough capital resources to cover the risks it is, or might be, exposed to. The impact is assessed mainly in terms of the DC ratio during and at the end of the time horizon.

(e) To assess possible responses to a stressed situation, IFAD may identify the credible actions that are most relevant. Stress-test results shall be used in combination with the capital planning results and managerial zones to assess potential responses that could be implemented ~~as a result of the stress test exercise:~~to safeguard IFAD's capital position.

- ~~Modification of capital buffer size.~~
- ~~Update of risk limits.~~

VII. Governance and responsibilities

50. **Executive Board.** The ~~proposed~~ Capital Adequacy Policy and regular updates will be submitted to the Executive Board for approval. The Executive Board will review the evolution of the capital ratios (DC ratio and CRA ratios) against the managerial zones and compliance with policy limits and CRA thresholds. It will also be responsible for approving Management action plans aiming to strengthen the capital position against the risk of breaching the established limits, following the recommendation of the Audit Committee.

51. **Audit Committee.** The Audit Committee will be entrusted with the task of recommending the ~~proposed~~ Capital Adequacy Policy and any amendments thereto to the Executive Board for approval. It will also be responsible for overseeing its implementation~~.~~, review the evolution of the capital ratios (DC ratio and CRA ratios) against the managerial zones and compliance with policy limits and CRA thresholds, and recommend to the Executive Board the approval of action plans presented by Management aiming to strengthen the capital position against the risk of breaching the established limits.

52. ~~**FISCO**~~**Management** shall be responsible for the continuous monitoring of IFAD's capital position and the establishment and periodical update of the thresholds within the preservation zone. Management shall periodically inform the Audit Committee and Executive Board on the evolution of capital, including the projections of the capital ratios (DC ratio and CRA ratios) within the managerial zones, policy limits and CRA thresholds.

53. **Enterprise Risk Management Committee (ERMC).** The ERMC will review the Capital Adequacy Policy and any amendments endorsed by the Financial Risk

Management Committee (FRMC) in accordance with the responsibilities established in the Terms of Reference of the IFAD Enterprise Risk Management Governance Committees.

54. **Financial Risk Management Committee.** The FRMC will assess and review regular updates to the Capital Adequacy Policy and will propose any necessary enhancements. The Committee will also be responsible for approving ~~the capital adequacy implementation guidelines.~~[12]any relevant procedures and guidelines that may be necessary to facilitate implementation of the Capital Adequacy Policy and for validating the stress-test programme.

55. **Financial Risk Management Unit (FRMU) of the ~~Financial Operations Department.~~** ~~The~~ **Office of Enterprise Risk Management** ~~Unit~~**.** The FRMU will be responsible for implementing the Capital Adequacy Policy and for monitoring and reporting on IFAD's capital consumption ~~and~~, deployable capital and other capital planning parameters to ~~FISCO.~~[13]the FRMC, the Audit Committee and the Executive Board.

56. The ~~Risk Management Unit~~FRMU will be responsible for running, monitoring and reporting the stress-test scenarios to ~~FISCO~~the FRMC and proposing ~~any change in the size of~~ the ~~buffer~~thresholds for managerial zones to the ~~Executive Board~~FRMC, if required.

VIII. Conclusion and recommendation

57. In accordance with efforts to ~~enhance~~continue enhancing IFAD's financial architecture, ~~and in order to incorporate the assessment of capitalization and capital planning in conjunction with existing liquidity management for the purposes of assessing the institution's financial capacity,~~ the Executive Board is invited to approve the Capital Adequacy Policy~~. Once approved, Management will assess and monitor the different metrics and limits included in this policy over an observation period of 6 to 12 months and report back to the Board accordingly.~~ as revised.

[12] ~~This function will be the responsibility of the new Finance and Risk Management Committee, once it has been established.~~
[13] ~~Reporting will be to the Finance and Risk Management Committee, once it has been established.~~

Glossary

Confidence level. Probability that the institution will remain solvent; derived from the generally very low probability that losses will be larger than available capital. A confidence level of 99.99 per cent means that there is a 0.01 per cent probability that losses will be higher than available capital. The confidence level is linked to the risk appetite of the institution, and in particular to its target rating.

Countercyclical. A movement in a direction different from the economic cycle trend. During economic downturns financial institutions generally have incentives to decrease the supply of credit due to the increase in capital requirements. ~~DFIs~~Multilateral lending institutions, on the other hand, should typically be prepared to maintain their lending ~~activity~~and operational activities to meet increased demand from borrowers and other beneficiaries during economic crisis.

Exposure at default. An estimate of the size of exposure (amount outstanding including disbursed and potential future exposures of undisbursed loans~~)~~ and other types of financing [if applicable]) at the time of default.

Loss given default. Estimated percentage of exposure the financial institution will lose if a counterparty and/or other relevant obligors' defaults.

~~**Maturity.** Effective maturity in years. According to Basel regulations, effective maturity is determined by a cash flow schedule formula. If the financial institution is not in a position to calculate the effective maturity of the contracted payments, it is allowed to use a more conservative measure of maturity such as that it equals the maximum remaining time (in years) that the borrower is permitted to take to fully discharge its contractual obligation under the terms of the loan agreement.~~

Probability of default. The probability that the counterparty and other obligors will default within a specific time horizon.

Risk-bearing capacity. Amount of risk a financial institution can take, usually determined as a function of its available capital against total development-related operations.

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

Time horizon. Time required to recover from a risk event once it occurs, or time required to reach resolution on a default event once it happens. When choosing a fixed time horizon, the financial institution should consider the time period during which it will not be possible to reduce risks or to attract additional capital if necessary.

Capital adequacy concepts

1. The amount of economic capital needed is derived from ~~expected loss and~~the unexpected loss. **Expected losses**[7] are normal to the business and would typically be covered by pricing and provisioning policies. **Unexpected losses** are potential losses that can only be covered by capital. Unexpected loss is the volatility of credit losses around expected loss.

2. **Economic capital** is an estimate of the overall capital reserve needed to guarantee the solvency of a financial institution for a given confidence level, typically set in accordance with the desired target rating. Basel defines economic capital as the methods or practices that allow financial institutions to consistently assess risk and attribute capital to cover the economic effect of risk-taking activities.

~~Figure 1~~
~~**Economic capital**~~

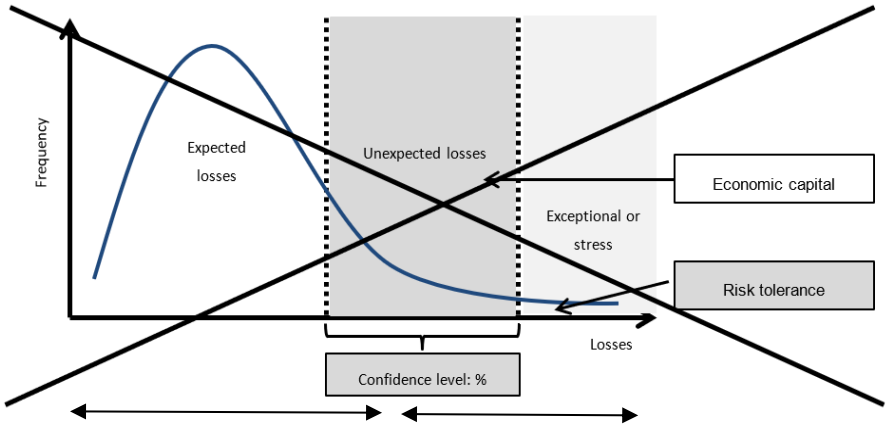
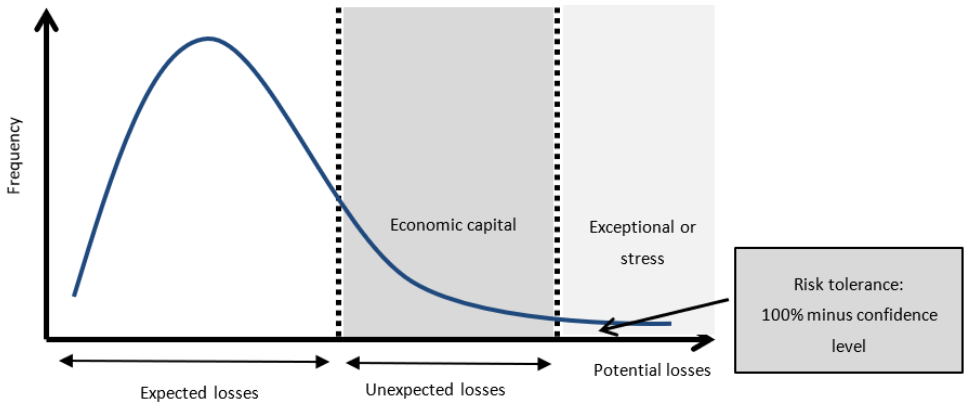


Figure 1
Economic capital



[7] In the context of IFAD's credit risk capital requirements, both expected and unexpected losses are considered, and accounting allowances for expected credit losses are added back to IFAD's equity to avoid double counting when computing the loss distribution. This ensures that any shortfall resulting from the different methodologies employed to compute expected losses will be captured in the capital adequacy assessment.

Exposure management framework

1. The exposure management framework will be a key pillar of the Capital Adequacy Policy, facilitating the strategic oversight of IFAD's current and forward-looking financial position. This limit framework will support capital management by setting prudential boundaries ~~through target and prudential limits~~ to optimize the Fund's capital utilization. The exposure management framework will be constructed attending to a three-tier limit structure as follows:

   (i) **Strategic or policy limit.** This limit is considered hard and must be met at all times to maintain IFAD as a going concern. In case of breach, immediate corrective action should be undertaken to return to the required level.

   (ii) ~~**Target**~~**Risk type limits.** Established for operationalization and planning purposes~~, target limits are set internally by institutions and serve as management thresholds~~.

   (iii) ~~**Prudential limits**. Prudential limits focus~~**Concentration limit.** This prudential limit focuses on operationalization of the lending activities in relation to risk exposures to single counterparties.

~~Table 1~~

STRATEGIC LIMIT (hard limit)		
Deployable capital	$DC = \frac{\text{initial capital available} - \text{total resources required} - \text{buffer}}{\text{initial capital available}}$	>0%
TARGET LIMITS		
Leverage	$\text{Leverage} = \frac{\text{financial liabilities}}{\text{Initial capital available}}$	35%-50%
Core risk capital consumption	$\text{Core risks} = \frac{\text{loan portfolio credit risk} + \text{net present value}}{\text{initial capital available}}$	<80%
Non-core risk capital consumption	$\text{Non} - \text{core risks} = \frac{\text{capital requirements for other risks}}{\text{initial capital available}}$	<10%
Buffer	10% of ICA	10%
PRUDENTIAL LIMITS		
Single country limit	$\text{Nominal country exposure} = \frac{\text{single country exposure in nominal terms}}{\text{initial capital available}}$	<20%

Table 1

Strategic or policy limit (hard limit)		
Deployable capital ratio	$\text{DC ratio} = \frac{\text{initial capital available} - \text{total resources required} - \text{buffer}}{\text{initial capital available}}$	>0%
Risk type limits		
Core risk capital consumption	$\text{Core risks} = \frac{\text{Development} - \text{related operations credit risk} + \text{net present value} + \text{equity investments risk}}{\text{initial capital available}}$	<80%
Non-core risk capital consumption	$\text{Non} - \text{core risks} = \frac{\text{capital requirements for other risks}}{\text{initial capital available}}$	<10%
Concentration limit		
Single country limit	$\text{Nominal country exposure} = \frac{\text{single country exposure in nominal terms}}{\text{initial capital available}}$	<20%

Capital optimization and capital preservation options

1. The Capital Adequacy Policy (CAP) introduced conservative managerial zones with a view to supporting capital planning and transparently monitoring the long-term evolution of DC ratio and credit rating agency (CRA) ratios.

2. This annex offers guidance for the implementation of potential alternative actions triggered by having reached one of the managerial zones established in the CAP.

3. The basic principle governing the capital planning process is that whenever IFAD remains within the comfort zone, IFAD will proactively optimize utilization of IFAD's capital base, which will require no additional action other than reporting through regular channels.[8] Upon determining that IFAD may fall below the comfort zone, Management will immediately notify the Audit Committee and the Executive Board of the situation and advise on the specific options for restoring IFAD's capital position.

4. The references below apply to the thresholds established for DC ratio or CRA ratios, meaning that actions would be triggered by the more stringent ratio among all capital ratios monitored.

5. **Comfort zone → continuous capital planning and balance sheet optimization.** Whenever IFAD remains within the comfort zone, it shall continuously implement regular financial management and capital optimization measures to enhance the Fund's capital base. The Audit Committee and the Executive Board shall be promptly consulted on the measures taken by Management. Notwithstanding the preceding, Management or the Executive Board could at any time proactively facilitate the discussion of balance sheet optimization measures to enhance IFAD's capital position.

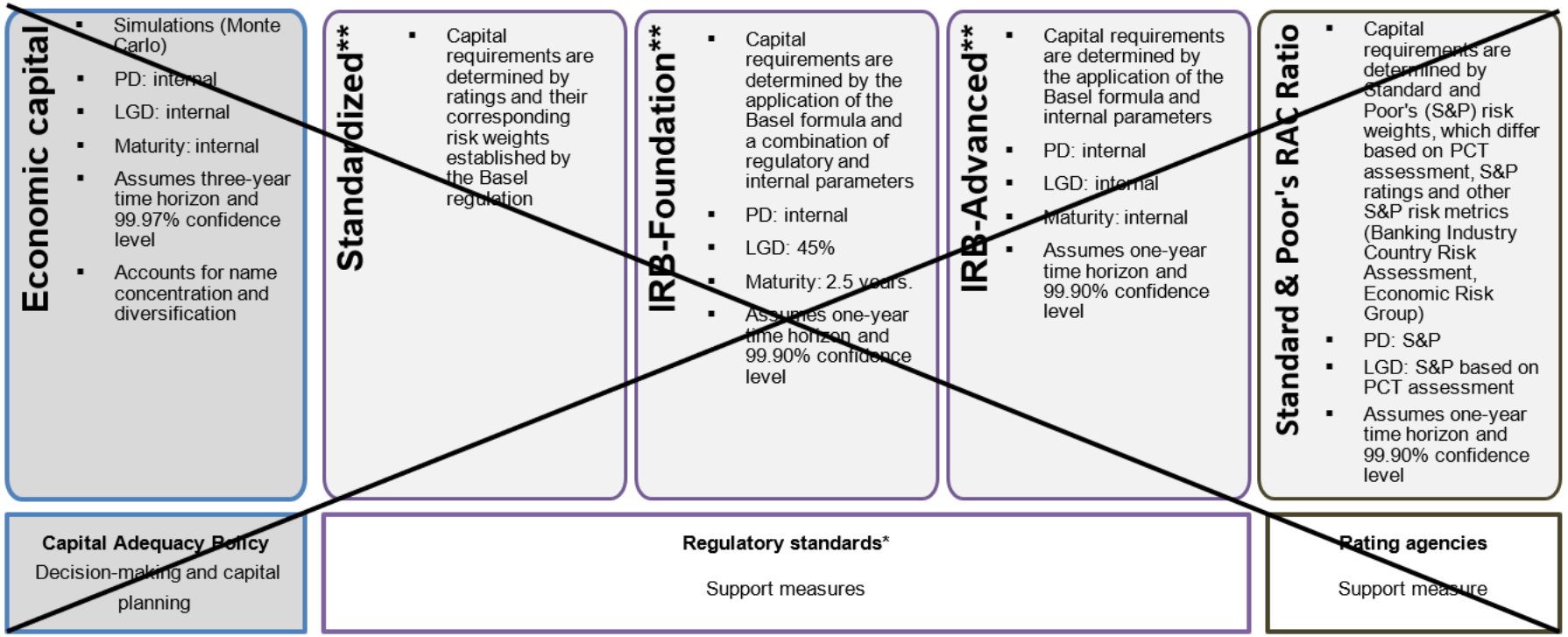
6. **Preservation zone → capital preservation measures.** Whenever IFAD is expected to reach the preservation zone, Management shall assess stronger capital preservation measures and take steps to preserve or restore IFAD's capital position. The Audit Committee and the Executive Board shall be promptly consulted on the measures taken by Management. Notwithstanding the preceding, Management or the Executive Board could at any time proactively facilitate the discussion of capital preservation measures to enhance IFAD's capital position.

Table 1
Examples of options to optimize and preserve IFAD's capital base

Continuous financial management and capital optimization	*Potential balance-sheet optimization measures*	*Potential capital preservation measures*
• Continuous review of commitment capacity • Periodic review of lending terms • Active portfolio monitoring (i.e. arrears, cancellation of unused resources) • Regular liquidity management • Regular review of operating efficiency (i.e. strategic budget planning)	• Exposure exchanges/securitization • Issuance of hybrid capital • Guarantees from highly rated donors.	• Enhanced sustainable replenishment baseline (reducing grant envelope) to meet capital generation target • Reduction in disbursements • Reduction of programme of loans and grants and Operational Expenses (OPEX) • Additional concessional partner loans

[8] E.g. replenishment exercise, resources available for commitment (RAC) within the replenishment cycle, etc.

~~Illustration of IFAD's approach to measure credit risk against other standards~~



~~* IFAD is not required to comply with any banking regulations~~

~~** For the measurement of credit risk, BCBS introduced two principal options, which have become an integral part of its continuous effort to enhance the banking regulatory framework. The first is the standardized approach, and the second the internal ratings-based (IRB) approach. There are two variants of the IRB approach: foundation and advanced.~~

- ~~**The standardized approach for credit risk.** In this approach, a financial institution allocates a risk weight to each of its assets and an off-balance sheet positions and produces a sum of risk-weighted asset values. Individual risk weights depend on the broad category of borrower (i.e. sovereigns, banks or corporates) and on a rating provided by a rating agency that meets strict standards.~~
- ~~Under the **IRB approach**, financial institutions are allowed to use their internal estimates of borrower creditworthiness to assess credit risk in their portfolios, subject to strict methodological and disclosure standards. In this approach, a financial institution estimates each borrower's creditworthiness, and the results are translated into estimates of a potential future loss amount, which forms the basis of minimum capital requirements.~~

Illustration of IFAD's approach to measuring credit risk against other standards

Economic capital	FRA ratio[a]	RAC ratio	Standardized	Internal ratings-based foundation and advanced
• Simulation-based (Monte Carlo) • Probability of default (PD): Internal • Loss given default (LGD): Internal • Maturity: Internal • Assumes a 3-year time horizon and 99.97% confidence level • Accounts for name concentration and diversification	• Capital requirements are determined by ratings and their corresponding risk weights, which are inspired by the Basel Committee's Standardized approach • Risk weights are adjusted for preferred credit treatment (PCT) and other risk mitigants when applicable	• Capital requirements are determined by Standard & Poor's (S&P) risk weights, which differ based on PCT assessment, S&P ratings and other S&P risk metrics (Banking Industry Country Risk Assessment [BICRA] and Economic Risk Group [ERG]) • PD: S&P • LGD: S&P based on PCT assessment • Assumes 1-year 99.90% confidence level	• Capital requirements are determined by ratings and their corresponding risks weights established by Basel regulation	• Capital requirements are determined through application of the Basel formula and a combination of regulatory and internal parameters • PD: Internal • LGD: 45% (internal for the advanced approach) • Maturity: 2.5 years (internal for the advanced approach). • Assumes a 1-year time horizon and a 99.90% confidence level

Capital Adequacy Policy	Rating agencies	Regulatory standards[b]
Key decision-making and capital planning	Reference measures for decision-making and capital planning	Support measures

[a] Fitch assesses supranational capitalization through two main indicators: Fitch's usable capital to risk-weighted assets (FRA) ratio and the (non-risk-weighted) equity-to-assets (E/A) ratio. The capitalization assessment is anchored to the FRA ratio. E/A is a complementary ratio. As with IFAD, under the Fitch FRA overall capital computation, a haircut is applied to concessional loans, which is then deducted from the equity.

[b] IFAD is not required to comply with any banking regulations.