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Enabling the rural poor  
to overcome poverty

## **Liquidity policy**

Executive Board — Eighty-ninth Session  
Rome, 12-14 December 2006

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For: **Approval**

## **Note to Executive Board Directors**

This document is submitted for approval by the Executive Board.

To make the best use of time available at Executive Board sessions, Directors are invited to contact the following focal point with any technical questions about this document before the session:

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## **Recommendation for approval**

The Executive Board is invited to approve the liquidity policy as proposed in paragraph 12.



## Liquidity policy

### I. Introduction

1. During the Consultation on the Seventh Replenishment of IFAD's Resources, IFAD was requested to "submit to the Executive Board in December 2006 for its review and approval a liquidity policy that will provide means of monitoring and ensuring that the Fund has adequate liquidity available at all times" (GC 29/L.4).
2. This paper first analyses and compares IFAD's aggregate financial obligations and cash inflows anticipated over the 2007-2009 period, and then reviews how liquidity is managed by the concessionary windows of other major international financial institutions (IFIs), i.e. the International Development Association (IDA), the African Development Fund (AfDF), the Asian Development Fund (AsDF) and the Fund for Special Operations (FSO) of the Inter-American Development Bank. In the light of this analysis, an adequate liquidity level for IFAD will be discussed. Liquidity adequacy will further be verified by assuming the individual as well as the simultaneous occurrence of various risk factors (liquidity shocks).
3. Based on the above discussion, the paper proposes a liquidity policy for IFAD for the Seventh Replenishment period.

### II. IFAD cash flow projections over the period 2007-2009

4. Under the base scenario for the Seventh Replenishment period (see table 1), average gross disbursements (cash outflows) would be US\$607 million per year. Of this, cash inflows would cover an average per year of about US\$469 million.

Table 1  
**IFAD cash flows, 2007-2009**  
 Millions of United States dollars

<i>Base scenario</i>	<i>2007</i>	<i>2008</i>	<i>2009</i>	<i>Total</i>
<b>Cash outflows</b>				
Loan and grant disbursements	(440)	(442)	(452)	(1 334)
Operating expenses and Programme Development Financing Facility (PDFF) <sup>a</sup>	(111)	(117)	(129)	(357)
Debt relief under the Debt Initiative for Heavily Indebted Poor Countries (HIPC)	(44)	(41)	(45)	(130)
<b>Total</b>	<b>(595)</b>	<b>(600)</b>	<b>(626)</b>	<b>(1 821)</b>
Average per annum				(607)
<b>Cash inflows</b>				
Contributions (drawdowns, encashments, cash payments)	199	167	199	565
Loan reflows (principal, interest, service charges) gross of HIPC	205	215	228	648
Net investment income	69	65	61	195
<b>Total</b>	<b>473</b>	<b>447</b>	<b>488</b>	<b>1 408</b>
Average per annum				469
<b>Cash flow gap</b>	<b>(122)</b>	<b>(153)</b>	<b>(138)</b>	<b>(413)</b>

<sup>a</sup> The amount for operating expenses and the PDFF for 2007 is based on figures proposed by the Office of Strategic Planning and Budget for administrative costs (US\$67.4 million) and the PDFF (US\$33.8 million), the Action Plan (US\$5.5 million) and the sum of the 2006 budget figures for the Field Presence Pilot Programme and Office of Evaluation. See the annex for the base scenario assumptions.

5. As shown in table 2, IFAD's investment portfolio can be divided into three different classes of assets in terms of the ability to convert them to cash in a short period of time without significant loss of value. Thus, apart from cash itself, short-term instruments such as bank time deposits and government securities are the most liquid assets. Non-government securities are less liquid (e.g. in terms of finding

another party ready to make the desired trade) but nonetheless can be encashed fairly easily, as demonstrated by the successful investment portfolio transition exercise in the third quarter of 2006. The least liquid part is the held-to-maturity portfolio in the sense that it is bound by accounting restrictions. However, 5 per cent of the held-to-maturity portfolio matures for reinvestment every quarter and can be redeemed for disbursement purposes if necessary. It also generates a constant stream of cash income through coupon payments.

Table 2  
**IFAD investment portfolio, 2006-2009**  
 Millions of United States dollars

<i>Base scenario</i>	<i>2006</i>	<i>2007</i>	<i>2008</i>	<i>2009</i>
Opening balance	2 348	2 371	2 249	2 096
<b>Cash flow gap</b>	<b>23</b>	<b>(122)</b>	<b>(153)</b>	<b>(138)</b>
Ending balance	2 371	2 249	2 096	1 958
<b>Ending balance composition<sup>a</sup></b>				
<b>(a) Highly liquid assets</b>	<b>1 143</b>	<b>1 074</b>	<b>985</b>	<b>906</b>
Short-term instruments	130	124	115	108
Government securities	1 013	950	870	798
As a percentage of the ending balance	48%	48%	47%	46%
<b>(b) Fairly liquid assets: Non-government securities</b>	<b>828</b>	<b>775</b>	<b>711</b>	<b>652</b>
As a percentage of the ending balance	35%	34%	34%	33%
<b>(c) Partially liquid assets: Held-to-maturity securities</b>	<b>400</b>	<b>400</b>	<b>400</b>	<b>400</b>
As a percentage of the ending balance	17%	18%	19%	21%

<sup>a</sup> The ending balance composition is based on the current investment policy. The ending balance of each year is carried over to the following year's opening balance.

- For the purposes of this paper, the term "liquidity" refers to the first class of assets mentioned above, i.e. the part of the investment portfolio that is highly liquid and can be converted to cash quickly, without significant loss of value.

### **III. Other IFIs' approach to liquidity**

- Managing liquidity as part of overall financial resources management is a common practice among other IFIs' concessionary windows. IDA, AfDF and AsDF couch their approach to liquidity in terms of ensuring cash requirements to cover disbursements, and this will be the point of departure for IFAD's liquidity policy (see table 3).

Table 3  
Overview of other IFIs' liquidity management

	IDA	FSO	AfDF	AsDF
General framework	Liquidity is managed as part of investment policy.	Liquidity is managed as part of lending capacity planning.	Liquidity policy was adopted as part of financial resources management.	Liquidity is managed as part of the financial resources framework.
<b>Total</b>	<b>US\$15 billion</b>	<b>US\$1.6 billion</b>	<b>US\$2.8 billion</b>	<b>US\$5.8 billion</b>
Composition	Invested in a full range of instruments including government and non-government securities, swaps and other derivatives	Invested in a full range of instruments including government and non-government securities	Invested in a full range of instruments including government and non-government securities	Invested in a full range of instruments including government and non-government securities
Held-to-maturity portfolio as a percentage of total	0%	0%	49%	56%
Measure of minimum liquidity (ML)	33% of the three-year moving average of gross disbursements	US\$500 million (lending would be suspended once liquidity hit this level)	50% of the subsequent year's projected gross disbursements	20% of the subsequent year's projected gross disbursements
<b>Purpose of ML</b>	<b>To meet unexpected cash flow demands</b>	<b>To preserve future lending capacity</b>	<b>To meet unexpected increase in cash flow demands</b>	<b>To cover disbursement needs unmatched by encashments</b>
<b>Current ML<sup>a</sup></b>	<b>US\$2.9 billion</b>	<b>US\$500 million</b>	<b>US\$1.4 billion</b>	<b>US\$300 million</b>
ML as a percentage of total	19%	31%	50%	5%

<sup>a</sup> Data based on fiscal year 2005. AsDF's ML is related to its loan reflows-based liquidity pool. AsDF sets a separate ML for another liquidity pool of encashments from donor contributions for each replenishment.

## IV. Liquidity shock analysis

8. To ensure a careful and prudent approach, IFAD's cash flow projections need to be further verified by assuming the individual as well as the simultaneous occurrence of various risk factors (referred to as liquidity shocks).
9. Within its asset liability management framework, IFAD assessed the risk elements and constraints (comparable to those considered for IDA's minimum liquidity requirements) that may impact IFAD's cash flow and liquidity position for the Seventh Replenishment period. The annex provides additional information on major risk factors, and table 4 presents the dimensions of these risks.

Table 4  
Summary of major risk elements and their impact on IFAD's liquidity, 2007-2009  
Millions of United States dollars

	<i>Amount per annum</i>
<b>(a) Average annual gross disbursements (cash outflows) over 2007-2009 under the base scenario (see table 3)</b>	<b>607</b>
<b>(b) Potential additional requirements due to liquidity shocks:</b>	<b>121</b>
Delayed encashments	40
Increased loan arrears	12
Changes in investment income due to value at risk	<u>69</u>
<b>(c) Total (a) + (b)</b>	<b>728</b>

10. The simultaneous occurrence of these liquidity shocks is deemed very unlikely. That being said, a careful and prudent approach is widely accepted as an industry practice and is used by other IFIs (see table 3). IFAD should therefore incorporate such a prudent approach in formulating its liquidity policy.

## **V. Proposed liquidity policy**

11. Under the base scenario for the Seventh Replenishment period (see table 1), the average gross disbursements (cash outflows) would be US\$607 million per year. Of this, cash inflows would cover an average per year of about US\$469 million. Potential additional cash requirements due to liquidity shocks (see table 4) would be US\$121 million. IFAD's liquidity has to be adequate to ensure that it can meet its obligations even in the unlikely event that all the liquidity shocks occur in the same year. As shown in table 3, other IFIs set their minimum liquidity to cover potential risks as follows: AfDF – 50 per cent of the subsequent year's projected gross disbursements; IDA – 33 per cent of the three-year moving average of gross disbursements; and AsDF – 20 per cent of the subsequent year's projected gross disbursements.
12. Taking this into account, and with a view to ensuring a prudent and cautious approach, it is proposed that IFAD set its minimum liquidity at 60 per cent of the total of annual gross disbursements (cash outflows) and potential additional requirements due to liquidity shocks. For the Seventh Replenishment period, this minimum liquidity level would mean 60 per cent of US\$728 million, i.e. US\$437 million. As shown in table 2, IFAD's liquidity ("highly liquid assets") throughout the Seventh Replenishment period is well above the proposed minimum liquidity level.
13. The Fund's liquidity status will be monitored and reported through the regular reports on IFAD's investment portfolio.

## **VI. Conclusions**

14. In accordance with the recommendation adopted by the Governing Council and in the light of the foregoing analysis and discussion, IFAD Management submits the liquidity policy described above in paragraph 12 to the Executive Board for its review and approval. The Fund's liquidity policy will be reviewed at the end of the Seventh Replenishment period to take account of changes in financial requirements and possible changes in the risk profile.



## Base scenario assumptions

1. The assumptions for the base scenario can be summarized as follows:

Table A-1

### Base scenario assumptions

<i>Major consideration</i>	<i>Assumption</i>
Member's contributions	Seventh Replenishment target level of US\$720 million with pledges to Regular Programme amounting to US\$600 million
Programme of work	2006 programme of work at US\$550 million, growing 10 per cent per annum during the Seventh Replenishment period (2007-2009)
Grant level	Stable at 10 per cent of the annual programme of work
Loan disbursements	Average 12-year disbursement profile with 17 per cent cancellations/reductions
Loan arrears	Stable at 3 per cent of loan reflows (principal and interest) per annum
Grant disbursements	4-year disbursement profile with 0 per cent cancellations/reductions
Administrative expenses	Increasing in line with programme of work growth
Investment return	2006 investment return at 1.75 per cent. Future investment return assumed at stable 3 per cent per annum
HIPC debt relief costs	Costs are updated as at latest estimates. No additional external contributions are taken into account
SDR/USD rates	2006 and future rates assumed at 31 July 2006 level of 1.4841

2. The following table details the major risk factors referred to in table 4 of the main text.

Table A-2

### Liquidity shocks and related assumptions<sup>a</sup>

<i>Type of liquidity shock</i>	<i>Assumption</i>
Delayed encashment of contributions	Under the Sixth Replenishment, a number of donors agreed with IFAD on special schedules for encashment of their promissory notes, thereby delaying encashment beyond a three-year period. This liquidity shock assumes that from the Seventh Replenishment onwards this trend will continue.
Increase in loan arrears	That loan arrears will increase <b>to 8 per cent</b> per annum from 2007 onwards (base scenario: 3 per cent per annum)
Changes in investment return due to Value at Risk (VaR)	That the investment loss will be as estimated by the VaR (at 3 per cent) of the investment portfolio (base scenario: no VaR assumed)

<sup>a</sup> IFAD financial model will be kept up to date to support projections of impact of any combination of liquidity shocks on IFAD's financial position.