Document: GC 41/L.6
Agenda: 9
Date: 20 December 2017
Distribution: Public
Original: English

E

Investing in rural people

Review of the adequacy of the level of the General Reserve

Note to Governors

Focal points:

Technical questions:

Mikio Kashiwagi
Associate Vice-President
Chief Financial Officer and Chief Controller
Financial Operations Department
Tel.: +39 06 5459 2403
e-mail: m.kashiwagi@ifad.org

Advit Nath
Director and Controller
Accounting and Controller's Division
Tel.: +39 06 5459 2829
e-mail: a.nath@ifad.org

Allegra Saitto
Chief
Financial Reporting and Corporate Fiduciary
Tel.: +39 06 5459 2405
e-mail: a.saitto@ifad.org

Dispatch of documentation:

William Skinner
Chief
Governing Bodies
Tel.: +39 06 5459 2974
e-mail: gb@ifad.org

Governing Council — Forty-first Session
Rome 13-14 February 2018

For: Approval

Recommendation for approval

The Governing Council is invited to approve the draft resolution on the revisions to regulation XIII of the Financial Regulations of IFAD contained in the annex.

Review of the adequacy of the level of the General Reserve

1. The review of the adequacy of the level of the General Reserve was examined in detail by the Audit Committee at its 145th meeting. This document was submitted thereafter to the Executive Board at its 121st session in September 2017. The Executive Board hereby submits the review to the present session of the Governing Council with a recommendation for approval of the draft resolution on the revision to regulation XIII of the Financial Regulations of IFAD as contained in the annex.

I. Executive summary

1. The General Reserve was established by the Governing Council in 1980[1] to address the potential risk of overcommitment of IFAD's resources as a result of:

- Exchange rate fluctuations;
- Possible delinquencies in the receipt of loan service payments;
- Possible delinquencies in the recovery of amounts due to the Fund from the investment of its liquid assets; and
- Potential overcommitment risk resulting from a diminution in the value of assets caused by fluctuations in the market value of investments.

2. Over the history of the Fund, the Executive Board has approved several transfers (between 1980 and 1994), bringing the reserve up to its current level of US$95 million. The General Reserve has never been used.

3. IFAD has always been mindful of financial risks, and Management has adopted several measures that, directly or indirectly, mitigate such risks. This has strengthened the financial framework in which IFAD operates, in line with evolving business practice.

4. With the introduction of the long-term sustainable cash flow approach as a mechanism to define IFAD's commitment capacity, the relevance of the General Reserve has decreased. Since the Ninth Replenishment of IFAD's Resources (IFAD9), risks of overcommitment of IFAD's resources have been mitigated by ensuring availability of sufficient liquidity to meet overall disbursement needs.

5. In accordance with accounting requirements, reserves are an equity component and, in particular, a component of retained earnings. Reserves represent appropriations of retained earnings (the accumulation of yearly net income). At the end of December 2016, retained earnings presented a negative balance of US$391 million (in nominal terms), while overall net equity presented a positive balance of US$7.8 billion.

6. In recognizing the sound financial framework in which IFAD operates and the intrinsic value of an equity component such as a reserve, it is recommended, in line with best industry practice, to enhance the General Reserve and consider it a flexible mechanism to mitigate risks and establish precautionary measures to cover the Fund's emerging financial risks, including those related to borrowing activities. For the current year, Management is proposing to maintain the General Reserve at its current level of US$95 million. This will be re-evaluated by Management during IFAD11.

7. The reason for enhancements to the General Reserve at this point in time is to support and mitigate relevant and new risks given the evolving IFAD business model, including enhanced borrowing activities, and to make the General Reserve more flexible and streamlined through a yearly review process.

II. Background

8. The General Reserve was established by the Governing Council in 1980 to address the potential risk of overcommitment of IFAD resources as a result of:

- Exchange rate fluctuations;
- Possible delinquencies in the receipt of loan service payments;
- Possible delinquencies in the recovery of amounts due to the Fund from the investment of its liquid assets; and

[1] Governing Council resolution 16/IV.

- Potential overcommitment risk resulting from a diminution in the value of assets caused by fluctuations in the market value of investments.

9. In 1999 the Governing Council[2] recognized the need to provide further cover for the Fund against a potential overcommitment risk resulting from diminution in the value of assets caused by fluctuations in the market value of investments.

10. In establishing the General Reserve, the Governing Council authorized the Executive Board to approve transfers from IFAD's net income up to a ceiling of US$100 million, taking into account the Fund's financial position. In 1999, the Governing Council decided that the ceiling of the General Reserve could be amended from time to time by the Executive Board, and required the Board to review the level of the reserve periodically.[3] The Audit Committee[4] is required, by its terms of reference, to review the adequacy of the General Reserve and to report its conclusions and recommendations to the Executive Board.

11. In line with the Financial Regulations of IFAD (regulation XIII), from 1980 to 1994 the Board approved several transfers from the surplus, bringing the reserve up to its current level of US$95 million.

12. From 1980 to 2013, IFAD's resources available for commitment were defined under the advance commitment authority scheme. Risks of overcommitment were assessed through the "resources available for commitment" definition, which was calculated by deducting from some IFAD assets (liquidity and promissory notes receivables) the level of commitment for undisbursed loans and grants and the balance of the General Reserve.[5]

13. Since the IFAD9 Consultation in 2011, financial scenarios and the amount of resources available for commitment have focused on IFAD's long-term cash flow sustainability. In order to preserve the long-term financial health of the Fund, projections of IFAD's commitment capacity must first and foremost be deemed sustainable in terms of cash flows. This means that IFAD's liquidity (i.e. the balance of its cash and investments) should not breach the minimum liquidity requirement stipulated in the Liquidity Policy over the next 40 years and that donor contribution requirements for a given programme of loans and grants scenario should be sustainable in future replenishments. The Agreement Establishing IFAD states, in article 7, section 2(b): "The proportion of the Fund's resources to be committed in any financial year ... shall be decided from time to time by the Executive Board with due regard to the long-term viability of the Fund and the need for continuity in its operations."

14. Lately, in 2012, 2015 and 2016, the Audit Committee and the Executive Board were presented with reviews of the General Reserve, inclusive of analysis of major financial risks and the related mitigation strategies in place. It was noted that the relevance of the General Reserve, as a measure to address some specific risk factors of overcommitment, has decreased owing to greater emphasis on cash flow and liquidity levels. The evolution of the IFAD business model with enhanced borrowing activities is also requiring different monitoring mechanisms. This document thus provides an updated summary of relevant measures to mitigate financial risks and of precautionary measures in place as at 31 December 2016, and it includes a proposal to enhance the General Reserve to mitigate risks associated with borrowing activities.

[2] GC 22/L.9.
[3] Regulation XIII(b), Financial Regulations of IFAD, as amended by the Governing Council at its thirty-fifth session.
[4] See "Terms of Reference and Rules of Procedure of the Audit Committee of the Executive Board", adopted in September 2009 (EB 2009/97/R.50/Rev.1).
[5] See EB/2013/108/R.20.

III. Financial risks

15. IFAD has been mindful of overcommitment and Management has adopted several measures that, directly or indirectly, contribute to further mitigate this risk in line with the evolution of the business practice, for example:

- Since 2012, IFAD's consolidated financial statements have been externally audited for accuracy of the accounts and also for the effectiveness of internal controls over financial reporting.
- During 2014, the accounting policy regarding provisioning of financial assets was strengthened to assess, further, the creditworthiness of all outstanding financial assets.
- The compensation mechanism for forgone principal – arising from implementation of the Debt Sustainability Framework – was approved with adoption of the resolution on IFAD10 by the Governing Council at its thirty-eighth session in February 2015.
- In April 2015, at its 114th session, the Executive Board approved the Sovereign Borrowing Framework (2015/114/R.17/Rev.1) with the purpose of defining parameters for borrowing from Member States and state-supported institutions, inclusive of a section on financial risks associated with borrowing activities and mitigation strategies.

16. As already reported during previous reviews, Management believes that the risks of overcommitment are being addressed effectively through operational and financial methods, as follows:

- The risk generated by exchange rate fluctuations is mitigated by matching the currency denomination of the Fund's assets (investment funds and loan receivables) to the currency of denomination of financing commitments (approved and undisbursed loans and grants). The Fund's assets are maintained in such a way as to ensure, to the extent possible, enough liquidity to meet disbursement requirements in any particular currency. It should be noted that even if currency risks are mitigated through matching of assets and commitments, foreign exchange movements have significant implications for IFAD accounts. The majority of IFAD's assets are denominated in special drawing rights (SDR), while the reporting currency is the United States dollar. As with any other entity operating in a multicurrency environment, any material fluctuations in the US$/SDR foreign exchange rate create volatility in IFAD's accounts at the time of translation of assets into United States dollars for reporting purposes, with periodically positive and negative movements. Foreign exchange movements are unrealized gains/losses on IFAD's profit and loss statement and do not have repercussions on the Fund's financial stability. The adoption of single currency loans will slowly reduce the accounting impact of foreign exchange movements, as IFAD assets will be denominated in United States dollars. To strengthen the possibility of proactively managing foreign exchange risks, IFAD is entering into an ISDA agreement[6] with major banks, which will enable the Fund to enter into cross-currency swaps and hedge more currency risks proactively.

[6] The International Swaps and Derivatives Association (ISDA) master agreement is the most commonly used master service agreement for international over-the-counter (OTC) derivatives transactions. It is part of a framework of documents designed to enable OTC derivatives to be documented fully and flexibly. The framework consists of a master agreement, a schedule, confirmations, definition booklets and a credit support annex. The master agreement is a document agreed between two parties that sets out standard terms that apply to all the transactions entered into between those parties. Each time a transaction is entered into, the terms of the master agreement do not need to be renegotiated and apply automatically.

- The risk associated with delinquencies in the recovery of amounts due to IFAD from the investment of its liquid assets is mainly managed by setting prudent credit ratings as defined in IFAD's Investment Policy Statement (IPS). Table 1 summarizes the credit rating floors as at 31 December 2016.

Table 1
Credit rating floors
Statement as at 31 December 2016

Eligible asset classes	*Credit rating floors for Standard & Poor's (S&P) 500, Moody's and Fitch*
Money market	Counterparty must have a minimum short-term credit rating of A-1 (S&P), F1 (Fitch) or P-1 (Moody's)
Fixed income, both nominal and inflation-linked	Investment grade
Government and government agencies fixed-income securities at national or subnational levels	Investment grade
Supranationals	Investment grade
Asset-backed securities (only agency issued or guaranteed)	AAA
Corporate bonds	Investment grade
Developed market equity	Investment grade
Currency forwards[a]	Counterparty must have a minimum short-term credit rating of A-1 (S&P), F1 (Fitch) or P-1 (Moody's)
Exchange-traded futures and options[a,b]	
Interest rate swaps[a]	
Cross-currency swaps	
Asset swaps	
Credit default swaps[a]	

[a] Derivatives used exclusively for hedging purposes.
[b] Futures and options are allowed if traded on regulated exchanges.
Source: 2016 IFAD consolidated financial statements.

- IFAD requires that its external investment managers and custodian bank exercise due diligence in selecting counterparties for investment transactions, and that futures and options be traded only on regulated exchanges. For time deposits and certificates of deposit, IFAD uses counterparties with a credit rating of not less than A-1 (S&P's) or P-1 (Moody's).

- The impact on IFAD's accounts caused by significant fluctuations in the market value of investments is closely linked to IFAD's IPS. As a mitigation measure, part of the investment portfolio has been designated at amortized cost. Moreover, IFAD's Liquidity Policy sets a minimum liquidity level for the portfolio. These measures have enabled IFAD to reduce the overall volatility of investment returns, effectively manage the market shocks linked to the financial crisis and better ensure the delivery of IFAD's commitments.

- Since 2012, IFAD has adopted conditional value at risk (CVaR)[7] as an additional risk measure. As shown in table 2, the CVaRs of all single asset classes and that of the overall portfolio were below prescribed risk budget levels and lower than in the previous year. It should be noted that the IFAD IPS is subject to yearly review to ensure that risk measures are properly calibrated to evolving market conditions.

Table 2
CVaR of IFAD's current asset classes as at 31 December 2016 and 2015

	Actual investment portfolio one-year CVaR		*One-year CVaR*
	31 December 2016	*31 December 2015*	*IPS budget level*
Asset liability portfolio (excl. cash)	1.48	6.68	8.00
Global liquidity portfolio	2.25	-	2.00
Chinese renminbi portfolio	1.68	-	2.00
Global government bonds	0.34	0.75	4.00
Global diversified fixed-income bonds	4.86	4.93	15.00
Global inflation-indexed bonds	6.27	7.15	9.00
Emerging market debt bonds	9.58	7.89	27.00
Total portfolio (including global strategic portfolio and operational cash)	**2.71**	**3.34**	**6.00**

Note: Confidence level at 95 per cent. Percentages based on historical simulations over five-year history.

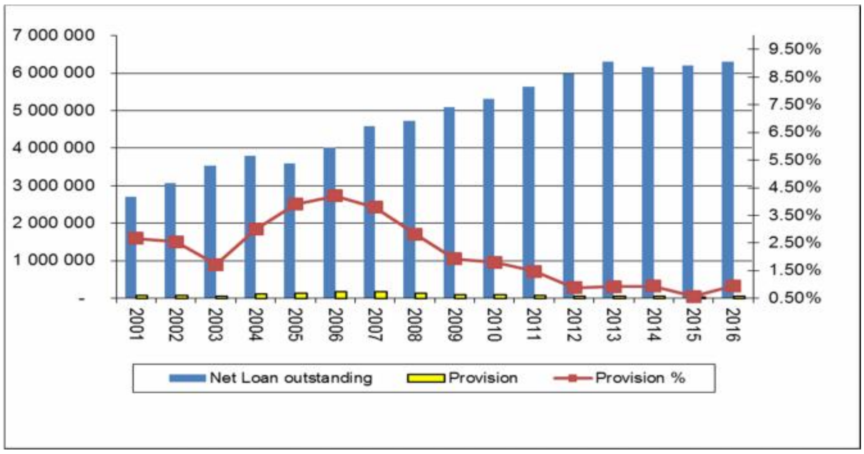
- The possibility of delinquencies in loan service payments is monitored on a weekly basis. An impairment provision is set up in the accounts for any uncertainty regarding the receipt of loan principal repayments according to the original repayment schedule.[8] As at 31 December 2016, this allowance amounted to some US$60 million in nominal terms, equivalent to 0.95 per cent of the balance of loans outstanding (US$6,300 million), well below the historical average of 2.1 per cent.

[7] Created as an extension of VaR, CVaR is not based on the assumption of normally distributed returns. The one-year CVaR at 95 per cent is a measure of the potential average expected loss of a portfolio, which is increased under extreme conditions (the so-called "left tail"). It gives an indication of how much value a portfolio could lose, on average, over a forward-looking one-year horizon with a 95 per cent confidence level. To derive this measure, the portfolio is revalued (stressed) assuming a large number of market condition scenarios affecting its value. For example, a CVaR of 6 per cent on a portfolio of US$1,000,000 means there is a 95 per cent chance that the average loss of the portfolio will not exceed US$60,000 in one year.

[8] See IFAD's 2016 consolidated financial statements: an allowance is established on a specific basis for such losses based on the difference between the assets' carrying value and the present value of estimated future cash flows discounted at the financial assets' original effective interest rate (i.e. the effective interest rate calculated at initial recognition). In cases where it is not possible to estimate with any reasonable certainty the expected cash flows of a loan (as in all cases for which an allowance has been established to date), an alternative approach is followed that adopts a method similar to the benchmark used for the provisioning of Member States' contributions. This means that an allowance shall be made on loan instalments overdue for more than 24 months. An allowance is also made for loan instalments on the same loan overdue for less than 24 months. Once this trigger period has been reached, all amounts overdue at that time are considered to be in provision status, even in the event that part of the total outstanding debt is subsequently repaid. In cases where more than 48 months have elapsed, an allowance is made for all outstanding principal amounts of the loan concerned. The point in time to determine whether the given period has elapsed is the balance sheet date. Considering the positive historical loan reflow trends for which losses have not been recorded so far, the Fund has not established a collective impairment provision on loans not subject to specific impairment. Income on loans is recognized following the accrual basis of accounting. For loans with overdue amounts in excess of 180 days, interest and service charges are recognized as income only when actually received. Follow-up action is being taken with the respective governments to obtain settlement of these obligations.

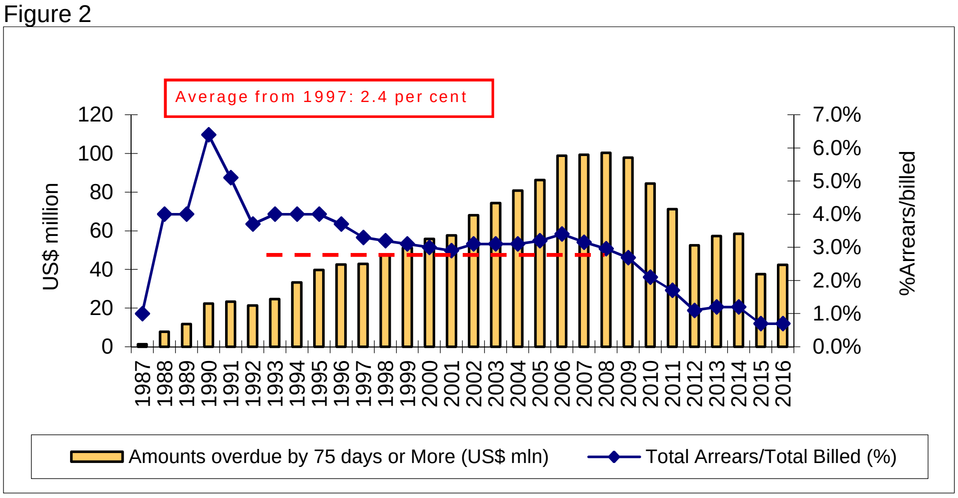
- Figure 1 shows historical trends for loans in arrears, comparing the provisions balance with the total value of outstanding loans.

Figure 1
(Thousands of United States dollars)



- Further to the accounting provisions, IFAD undertakes operational measures to reduce the risk of accumulating arrears balances, such as discontinuing disbursements of loans that are 75 days in arrears and suspending the entire portfolio. Figure 2 shows some historic trends of IFAD non-performing loans. As at 31 December 2016, non-performing loans were equivalent to 0.7 per cent, which is well below the historical average.

Figure 2



- By 2018, IFAD must adopt a new accounting principle (IFRS9[9] impairment section). This accounting principle will imply a more stringent policy in terms of impairment allowance of loan outstanding receivables. Under IFRS9, the impairment will be calculated with a forward-looking approach. It will be based on expected credit losses (ECL) of financial instruments throughout their life cycle. This requires an entity to assess the probability of default at origination/purchase and until the end of the maturity period of the underlying financial assets and to set aside an impairment allowance reflecting the underlying credit risk (i.e. ECL). The ECL valuation will be updated and monitored continuously to reflect changes in the evolution of the credit risk of the underlying financial instruments. This will further strengthen debt-servicing monitoring measures.

[9] International Financial Reporting Standards.

17. The financial position and the proactive management of underlying financial risks are also visible from the major financial ratios:

- As explained earlier, since IFAD9, a greater emphasis has been placed on cash flow and liquidity levels to preserve the long-term financial health of the Fund. Prudent liquidity risk management includes maintaining sufficient cash and cash equivalents to meet loan and grant disbursements, as well as other administrative outflows as they arise. As at 31 December 2016,[10] the liquidity position of the Fund remained strong, with sufficient liquid assets to cover projected disbursement needs for more than two years.[11]
- The long-term financial viability of the Fund is monitored closely through an asset liability model and is reviewed by IFAD Management regularly, as well as by IFAD's Member States during replenishment consultations.
- Term structure risks are the financial risks that usually result when the timing and/or financial maturity of cash flows (i.e. principal and interest) between assets and their funding liabilities do not match. Funding, refinancing and reinvestment risks are three of the most typical of these risks.
- IFAD has no significant exposure to term structure risks because it is mainly funded by equity (i.e. reserves and contributions), which, by definition, do not entail specific interest/principal repayments.
- Under the current financial mechanism (inclusive of borrowing), and despite negative retained earnings, IFAD's net equity is positive and its financial situation is sound. At the end of December 2016, total equity (contributions plus General Reserve) over total assets was equivalent to 97.3 per cent in nominal terms. As an additional indicator of risk, the Sovereign Borrowing Framework requires that the debt/equity ratio[12] shall not exceed 35 per cent. The ratio stands at 3.3 per cent as at the end of December 2016.
- All financial risk parameters are well within the thresholds established by the Sovereign Borrowing Framework as adopted in April 2015. The financial ratios are summarized in table 3, highlighting IFAD's current financial strength and ability to absorb potential losses.

Table 3
Financial ratios as at December 2016

	December 2016	*Threshold*
Equity/total assets	97.3%	>60%*
Debt/equity	3.3%	<35
Liquidity	15.9%	>5%
Liquidity/disbursement needs	2.3 years	-
Debt service coverage	0.1%	<50%

* Threshold established in the Framework Agreement with KfW Development Bank.
Source: EB2017/120/INF.4.

IV. Accounting (disclosure requirement) and the external auditor's views

18. The framework of the International Accounting Standards Board for preparation and presentation of financial statements sets out the concepts underlying these

[10] EB 2017/120/R.15 and EB 2017/120/INF.4.
[11] IFAD liquidity US$1,334.5 million/net disbursement needs in accordance with the minimum liquidity ratio of US$582.5 million = 2.3 years.
[12] The debt/equity ratio is: (a) the ratio of (i) principal portion of total outstanding debt to (ii) total contributions plus General Reserve (expressed in percentage terms); (b) calculated as (total outstanding debt principal/contributions plus General Reserve).

statements prepared in conformity with IFRS and defines the various elements from which financial statements are constructed. In this context, equity is defined as "funds contributed by shareholders, retained earnings, reserves representing appropriations of retained earnings and reserves representing capital maintenance adjustments." Moreover, reserves are considered a classification within retained earnings as an additional measure of protection from the effects of losses, usually in compliance with statutory requirements. Reserves comprise all undistributed income that remains invested in the reporting entity. Thus retained earnings are appropriation of yearly net income.

19. Reserves are sometimes required by statute or other law to give the entity and its creditors an added measure of protection from the effects of losses. The existence and size of these reserves is information relevant to the decision-making needs of users.

20. Transfers to such reserves are appropriation of retained earnings rather than expenses. IFAD's General Reserve constitutes an appropriation of income for accounting purposes. It has been separately disclosed on the face of the balance sheet as part of IFAD's capital and reserves since 2006. IFRS requirements remain unchanged as of this date in this respect.

21. As at the end of December 2016, retained earnings presented a negative balance of US$391 million (in nominal terms), the General Reserve presented a positive balance of US$95 million, while overall net equity presented a positive balance of US$7.8 billion (in nominal terms).

22. As regards the classification of the General Reserve within IFAD's capital and retained earnings, as at 31 December 2016, IFAD's external auditors considered this appropriate and consistent with the relevant documentation[13] provided by Management in support of this classification. The external auditors are not in a position to comment on the adequacy or appropriateness of the amount or level of the General Reserve, this clearly being solely a managerial decision.

V. Comparison with other international financial institutions

23. In general, other international financial institutions (IFIs) have a different funding structure: they borrow from the market and consider reserves as a capital component to mitigate mismatches between assets and their funding liabilities (term risk). The concessional lending arms of IFIs – which are closer to IFAD in terms of activity – do not in general have specific reserves similar to IFAD's General Reserve in their balance sheets, as they are assured of support from the "parent" group in case of resource shortages.

24. In view of the above fundamental differences, a detailed comparison was not performed, as it would not have been meaningful. Some information on the capital structure of other IFIs follows:

- Retained earnings of the World Bank Group include earnings from current and prior years, as well as specific reserves set up to cover liabilities incurred in the event of defaults on loans made, in addition to other reserves and surpluses. IDA financial statements do not include any amount set aside as a reserve.
- Retained earnings of the Asian Development Bank include various reserves, accounts and surpluses, such as a loan loss reserve, special reserve and ordinary reserve.

[13] This documentation consists of internal position papers and formal decisions by the Governing Council, confirming the original basis for setting up the General Reserve in 1980 and the amounts allocated to the General Reserve over the period 1980 to 1994.

- Retained earnings of the Inter-American Development Bank include both a special reserve, established for covering liabilities incurred in the event of defaults on loans made, and a general reserve, consisting of income from prior years.
- Retained earnings of the African Development Bank include some reserves related to assets designated to fair value through other comprehensive income, and to remeasurement of defined liabilities. African Development Fund accounts do not include any amount set aside as a reserve.
- Retained earnings of the European Bank for Reconstruction and Development include several reserves: in particular, the special reserve established to cover for certain loss events; a loan loss reserve to set aside retained earnings to cover potential loan losses; and a general reserve, consisting of income from prior years.

VI. Conclusions and recommendation

25. Throughout the years, several mitigation measures have been adopted to address financial risks historically covered by the General Reserve.

26. In line with best industry practice, recognizing the intrinsic value of an equity reserve as a mechanism to ensure a sound financial framework, and considering the evolution of the IFAD business model with enhanced borrowing activities – and the consequent increasing risks associated with the ability to meet financial obligations connected to borrowing liabilities – it is proposed to:

    (a) Maintain the General Reserve at the current level of US$95 million. The level of the reserve will be re-evaluated by Management during IFAD11;

    (b) Enhance the General Reserve and consider it a mechanism to mitigate risks and establish precautionary measures, including those associated with borrowing activities.

    (c) Further strengthen IFAD’s financial position by allocating to the General Reserve a defined portion of net income that may be derived from future fiscal years. Appropriation of yearly net income will be approved by the Executive Board in the context of the review/approval of the yearly audited financial statements of the Fund; and

    (d) Enhance the General Reserve as a flexible mechanism to address risks, and remove the ceiling of the General Reserve currently set at US$100 million.

27. The Executive Board is also invited to consider the draft resolution on the revisions to regulation XIII of the Financial Regulations of IFAD contained in the annex and to approve its submission to the Governing Council for adoption at its forty-first session in February 2018.

New text is shown in boldface and strikethrough indicates deleted text.

Resolution .../XLI

Draft resolution on revisions to the Financial Regulations of IFAD

The Governing Council of IFAD,

Acting under article 6, section 2(f) of the Agreement Establishing IFAD;

Recalling resolution 16/IV and resolution 111/XXII whereby a General Reserve was established;

Decides that:

Regulation XIII of the Financial Regulations of IFAD shall be amended to read as follows:

Regulation XIII

A General Reserve shall be established to cover the Fund's potential ~~overcommitment~~ risk as a result of exchange rate fluctuations and borrowing activities, possible delinquencies in receipt of loan service payments, ~~or~~ as well as in the recovery of amounts due to the Fund from the investment of its liquid assets.

The following dispositions shall be implemented with respect to the General Reserve:

(a) Annual transfers from the accumulated surplus to the General Reserve shall be determined by the Executive Board after taking into account the Fund's financial position in the context of the review/approval of yearly audited financial statements of the Fund;

~~(b) The adequacy of the General Reserve shall be periodically reviewed by the Executive Board;~~

(b)~~(c)~~ ~~Subject to the above, t~~ The ceiling of the General Reserve may be amended from time to time by the Executive Board;

(c) Withdrawals from the General Reserve shall be subject to the prior approval of the Executive Board;

(d) This resolution and the revisions to the Financial Regulations of IFAD shall enter into force upon the adoption of this resolution and shall have effect from financial year 2018.