Distribution: Restricted | REPL.VII/2/R.3 | 6 April 2005
Original: English | Agenda Item 4 | English

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IFAD

INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT

Consultation on the Seventh Replenishment of IFAD's Resources – Second Session

Rome, 21-22 April 2005

ASSET LIABILITY MANAGEMENT FRAMEWORK

I. BACKGROUND

1. The Consultation on the Sixth Replenishment of IFAD's Resources[1] recommended that IFAD management conduct a review in 2003 of the organization's investment policy as it pertained to the security of investments, asset liability management and reporting to the Executive Board, with a view to bringing that policy in line with standards and principles used by other development lending institutions. IFAD management carried out the review by dividing the work into the three areas indicated by the Governing Council, and presented the findings to the Executive Board in December 2003.

2. During this review, IFAD's current systems were analysed and an asset liability management (ALM) framework was developed. In December 2003, this framework was presented to the Executive Board, which endorsed it as a means to effectively manage exposure to financial risks. A progress report on the implementation status of the framework was presented to the Executive Board informal seminar in June 2004.

3. Based on its technical analysis, the ALM review proposed as one of its four action points that the definition of IFAD's committable resources be broadened. In this way, IFAD would be able to increase the level of resources available for new loan and grant commitments. However, due to the fact that the Sixth Replenishment resolution had already been adopted with specific modalities for the use of advance commitment authority, the ALM review recommended that the proposal be considered during the Seventh Replenishment negotiations.

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[1] Document GC 26/L.4: Enabling the Rural Poor to Overcome their Poverty: Report of the Consultation on the Sixth Replenishment of IFAD's Resources (2004-2006).

II. THE ASSET LIABILITY MANAGEMENT FRAMEWORK

A. Introduction

4. In working to achieve its overall vision to enable the rural poor to overcome poverty, IFAD aims to efficiently maximize resources available to its borrowing Member States while maintaining its financial soundness.

5. The financial soundness of an organization is reflected in the value of assets, liabilities and equity on its balance sheet. All financial institutions, including IFAD, are exposed to a series of financial risks on their balance sheets. ALM focuses on identifying, understanding and managing those risks while pursuing the institution's financial objectives.

6. The 2003 ALM review provided an overview of IFAD's overall ALM and risk exposures. It also recommended, where appropriate, alternative strategies to more efficiently manage IFAD's balance-sheet assets and liabilities in order to meet the organization's financial objectives of preserving the value of its investment portfolio and earning investment income, while lowering the volatility of investment returns and minimizing financial risks.

B. Implementation of the Framework

7. The ALM review's first action point was to create a separate ALM section under the Treasurer to focus on the management of assets, liabilities and their related risks. The new section, which was established in January 2004, enables IFAD to take ALM decisions that are less fragmented, more accurate and informed, and better coordinated. As part of its core functions, the ALM section analyses and monitors financial risks related to changes in market prices, interest rates, exchange rates, credit risk and the institution's liquidity position, and contributes to the development and implementation of new financial policies and procedures.

8. IFAD's existing financial model was consequently transferred to and expanded by the new section in line with the broader ALM perspective, whereby financial risks and policies are evaluated based on their projected long-term impact on the institution's future balance sheet, as well as its income statement and resources available for new loan and grant commitments.

9. As a second action point, the ALM review recommended that IFAD examine the unhedged currency exposure taken by some investment managers, despite the fact that IFAD's overall currency management policies were considered sound. IFAD's investment guidelines were consequently modified as of 30 June 2004 to eliminate the possibility of unhedged currency exposures.

10. As a third action point, the ALM review suggested that market risk in the investment portfolio could be further reduced by allocating a portion of the portfolio as 'held-to-maturity'. In 2004, following an ALM analysis of the financial impact of the held-to-maturity approach, it was decided that USD 400 million would be allocated to a held-to-maturity portfolio with a maximum maturity of five years. Furthermore, following a series of ALM analyses of the impact on the investment portfolio's expected risk and return, it was decided to liquidate the remaining equities portfolio and a portion of the government bonds portfolio and to invest the liquidation proceeds in the held-to-maturity portfolio during the first quarter of 2005. The decision to disinvest from equities, together with implementation of the held-to-maturity portfolio, will further significantly reduce the portfolio's exposure to market risk.

11. The ALM review also noted that IFAD had little exposure to term structure risk in its traditional sense and that the organization was well covered against credit risk exposure in terms of its investment portfolio, loan portfolio and Member States' contributions.

12. With regard to liquidity risk, the ALM review highlighted that exposure was minimal for IFAD owing to its highly liquid investment portfolio. Furthermore, compared with other international financial institutions, IFAD's level of liquid assets was high in relation to the lending programme and the level of annual loan disbursements. The ALM review therefore led to an analysis of IFAD's financial resource management and its definition of committable resources, as described in the next section. The review suggested, as a fourth action point, an alternative strategy to better utilize IFAD's liquid assets and, at the same time, increase resources available for commitment under loans and grants to Member States.

III. FINANCIAL RESOURCE MANAGEMENT AND THE DEFINITION OF COMMITTABLE RESOURCES

13. IFAD's practice has been to have full upfront financial backing, in the form of cash, investments and promissory notes, when approving new loans and grants. This conservative or 'static' approach has been followed despite the fact that 90% of such approvals (i.e. the loan portion) takes many years to disburse and, during that period, IFAD can count on new resource inflows from lending reflows, investment income and replenishment contributions.

14. The advance commitment authority (ACA) – in use since 2001 – has allowed some deviation from this practice, albeit to a limited extent. The ACA concept is based on the future loan reflows and the ability of an organization to meet disbursement requirements as they fall due. Under an ACA, stable and predictable future resources arising from loan reflows can be committed in advance. IFAD's Sixth Replenishment resolution states that the Executive Board may approve ACA within a ceiling of three years' worth of loan reflows.

15. The conservative approach of upfront financial backing is typical of a relatively young institution that needs to build up a strong financial base. This approach has served IFAD well. Funds set aside at each Executive Board session to back new loans and grants are held in the investment portfolio until disbursements fall due. Thus, over the years, IFAD has been able to build up an investment portfolio,[2] which is generating substantial investment income.

16. Liquidity risk is so minimal for IFAD that it could be argued that it impedes achievement of the goal of efficiently maximizing resources available to IFAD's borrowing Member States while maintaining the financial soundness of the institution. By changing the definition of committable resources, lending levels could in fact be increased, while remaining within prudent liquidity levels.

17. At the present time, IFAD's committable resources include only cash and investments, and promissory notes.[3] If the definition were revised to include loan receivables and Member States' instruments of contribution receivables (which reflect amounts receivable against deposited instruments of contribution), this would increase the level of resources available for commitment and, consequently, enable IFAD to increase its lending level. The effect of increased loan commitments, and therefore increased loan disbursements, would in practice lead to an asset reallocation from the investment portfolio to the loans outstanding portfolio. This seems appropriate since IFAD's mission is to reduce poverty by providing resources to its borrowing Member States, rather than investing assets in the financial markets.

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[2] According to the Audited Financial Statements of IFAD as at 31 December 2004 (document EB 2005/84/R.37), Appendix B (IFAD-only) and Notes 15 and 16, the total value of cash, investments and investment receivables and payables amounted to USD 2 559 975 000. See also the Report on IFAD's Investment Portfolio for 2004 (document EB 2005/84/R.32).

[3] See the Minutes of the Thirty-Fourth Session of the Executive Board (1988), paragraph 15(b)(i) on the Policy for Determining Resources Available for Commitment.

18. Explained from an accounting perspective, the proposed change in the definition simply entails including loan receivables and Member States' instruments of contribution receivables as part of committable resources. This is shown in the following table, which compares IFAD's audited balance sheet at 31 December 2004 with the current and proposed definitions of committable resources.

Comparing the Balance Sheet as at 31 December 2004 with the Current and the Proposed Definitions of Committable Resources[a]
(USD million)

Balance Sheet		**Statement of Resources Available for Commitment**	**Current Definition**	**Proposed Definition**
Assets:		Assets in freely-convertible currencies:		
Cash and investments	2 722	Cash and investments	2 722	2 722
Promissory notes (net)[b]	270	Promissory notes (net)[b]	268	268
Contributions receivables (net)[c]	258	***Contributions receivables (net)***[c]	-	***258***
Other receivables	154	Other receivables	154	154
Loans outstanding (net)[d]	3 799	***Loans outstanding (net)***[e]	-	***919***
Total Assets	**7 203**	**Total Assets**	**3 144**	**4 321**
Liabilities:		Less:		
Payables and liabilities	264	Payables and liabilities, and PDFF		
Undisbursed grants	36	carry-forward	268	268
		Undisbursed loans and grants	2 918	2918
		(including undisbursed effective, signed but not yet effective as well as not yet signed loans and grants)		
Contributions	4 668			
Fully committed retained earnings	2 140			
General Reserve	95	General Reserve	95	95
Total Liabilities, Contributions and Retained Earnings	**7 203**	**Net Resources**	**(137)**	**1 040**
		ACA approved by the Executive Board	**137**	n.a.
		ACA ceiling[f]	**653**	n.a.
		Unused ACA	**516**	n.a.

[a] Source: Audited Financial Statements of IFAD as at 31 December 2004: Appendix B (IFAD-only) for the Balance Sheet, Appendix D for the Statement of IFAD-Only Resources Available for Commitment, and Note 14.
[b] Promissory notes of USD 352 804 000 less provisions of USD 83 152 000 (additionally, in the resources available for commitment, less promissory notes in non-convertible currencies of USD 1 399 000).
[c] Contributions receivables of USD 351 569 000 less provisions of USD 93 140 000.
[d] Loans outstanding of USD 4 153 208 000 less accumulated allowances for loan impairment losses of USD 114 060 000 and for the Highly Indebted Poor Countries (HIPC) Debt Initiative of USD 240 112 000.
[e] Including five years of loan reflows (2005-2009), which have been conservatively defined as 95% of each year's principal and interest. Furthermore, the five years of loan reflows exclude projected foregone principal and interest reflows due to the HIPC Debt Initiative, to the extent contributions to IFAD's HIPC Debt Initiative are not sufficient to cover such forgone reflows.
[f] Three years (2005-2007) of projected loan principal and interest reflows.

19. As shown in the above table, the inclusion of Member States' instruments of contribution receivables and loan receivables as part of committable resources would increase the amount of net resources available for new commitments. It is noted that the same result could be achieved if the level of the allowable ACA were to be increased. However, in a way, ACA implies that the institution is gaining access to funds that it does not have, which is not financially true because, in fact, loan receivables (i.e. loans outstanding) make up the biggest asset on IFAD's balance sheet. Rather than continuing to apply ACA, it is financially sound merely to recognize the assets that the Fund has in its books and to include them, net of allowances for the sake of prudence, as part of committable resources.

20. As noted, loan receivables and Member States' instruments of contribution receivables were not previously included as part of committable resources because IFAD has always taken a very conservative approach to resource management. However, after 28 years of operations, the Fund now has a history on which to base its financial projections. The praxis of excluding loan receivables and Members' instruments of contribution receivables entirely from committable resources suggests that Member States will not fulfil their obligations. The track record shows that there have been very few delinquent borrowers; the level of loans requiring an allowance in the audited financial statements was only 2.7% of total loans outstanding as at 31 December 2004.

21. Changing the definition of committable resources may generate an element of risk in the same way as raising the ACA ceiling might do. From a liquidity management point of view, and considering that IFAD's loans have extremely long maturity periods, a cautious approach would be to limit loan reflows to a fixed number of years, say five years to begin with, in the committable resources definition. This would allow IFAD to proceed with a gradual and financially prudent use of the resulting resource availability. Secondly, the ALM review's technical analysis, and subsequent analyses performed with the expanded ALM financial model, have shown that, by including five years of loan reflows as part of committable resources, IFAD can remain within acceptable risk limits even with the resulting lower liquidity level. A financial scenario is attached[4] illustrating a gradual use of the resource availability resulting from the proposed definition of committable resources.

22. In conclusion, given the increase in demand for support for rural poverty reduction, the time is appropriate to revisit IFAD's current definition of what constitutes committable resources. IFAD should consider whether it should move to a more 'dynamic' type of financial resource management as other international financial institutions have done.[5] That would mean adopting the ALM approach by which operations are calibrated so as to ensure that sufficient liquidity is available to meet disbursement requirements at the time the funds are actually needed. This approach can be implemented within the context of a sound ALM framework, which includes built-in checks and controls to prudently manage financial risks, regular monitoring and ample leeway for correction in case of unforeseen developments.

4 The same scenario is also attached to the "The Way Forward" document (document Repl. VII/2/R.2).

5 Such as the Asian Development Bank's Asian Development Fund, the World Bank's International Development Association and the Inter-American Development Bank's Fund for Special Operations.

Scenario for the Seventh Replenishment Period:
Seventh Replenishment of USD 800 million,
Programme of Work Growing 10% Annually

1) Scenario Assumptions:

- 7th Replenishment of USD 800 million.
- Programme of Work USD 550 million in 2006 and growing 10% annually in 7th Replenishment period.
- Grants at 10% of Programme of Work.
- Definition of committable resources based on the Asset Liability Management framework, including Member States' instruments of contribution receivables and, in this scenario, 5 years of loan reflows as part of committable resources. The included loan reflows are conservatively defined as 95% of each year's principal and interest, excluding projected foregone principal and interest reflows due to HIPC DI, to the extent contributions to IFAD's HIPC DI are not sufficient to cover such foregone reflows.
- USD/SDR foreign exchange rate of 1.5498 at 31 December 2004 and maintained in future.

2) Scenario Results:

The table below shows the annual level and growth of the programme of work, when assuming a 10 % annual growth in the 7th replenishment period 2007-2009, whereby the programme of work would reach a level of USD 732 million in 2009.

Year	**2005**	**2006**	**2007**	**2008**	**2009**
Programme of Work (USD million)	500	550	605	666	732
Programme of Work Annual Growth (%)		10%	10%	10%	10%

This scenario would reach a 59% usage of 5 years, equivalent to 3.1 years, of future loan reflows for commitments during the 7th replenishment period. Projections show an acceptable liquidity level in the 7th replenishment period. Long-term liquidity projections depend on a number of assumptions for future replenishment periods, including programme of work and replenishment levels.

	6th Repl. 2004-2006	**7th Repl. 2007-2009**
Total Replenishment Target Level (USD million)	560	800
Average Annual Replenishment Level (USD million)	187	267
Average Annual POW (USD million)	513	668
Maximum Annual Usage of 5 Years of Future Loan Reflows (%)	46% 1)	59%
Lowest Liquidity Level in Period (USD million)	2 484	2 349

1) Based on the current ceiling of advance commitment authority.

3) Additional Scenario Information Based on Possible Trends in the 8th Replenishment Period:

3a) Scenario results for the 8th Replenishment Period if Assuming a Continued 10 % Annual Growth of Programme of Work in the 8th Replenishment Period

The table below shows the annual level and growth of the Programme of Work, when assuming a continued 10 % annual growth also in the 8th replenishment period 2010-2012, whereby the Programme of Work would reach a level of USD 974 million in 2012.

Year	2010	2011	2012
Programme of Work (USD million)	805	886	974
Programme of Work Annual Growth (%)	10%	10%	10%

This programme of work could be sustained in the 8th replenishment with a replenishment of USD 1 100 million. This scenario would fully use the five years of loan reflows for commitments. Projections of liquidity show an acceptable liquidity also in the 8th replenishment period and lower but sustainable liquidity for several later replenishment periods, if assuming that the levels of replenishment and programme of work would be maintained in real terms.

	8th Repl. 2010-2012
Total Replenishment Target Level (USD million)	1 100
Average Annual Replenishment Level (USD million)	367
Average Annual POW (USD million)	888
Maximum Annual Usage of 5 Years of Future Loan Reflows (%)	100%
Lowest Liquidity Level in Period (USD million)	2 352

3b) Scenario results for the 8th Replenishment Period if assuming 8 % Annual Growth of Programme of Work in the 8th Replenishment Period

The table below shows the annual level and growth of the programme of work, when assuming 8 % annual growth in the 8th replenishment period 2010-2012, whereby the programme of work would reach a level of USD 922 million in 2012.

Year	2010	2011	2012
Programme of Work (USD million)	791	854	922
Programme of Work Annual Growth (%)	8%	8%	8%

This programme of work could be sustained in the 8th replenishment period if assuming an 8th replenishment level of USD 1 000 million. Also this scenario would fully use five years of future loan reflows for commitments. Projections of liquidity remain acceptable for the 8th replenishment period and show lower but sustainable liquidity for several later replenishment periods if assuming that the levels of replenishment and programme of work would be maintained in real terms.

	8th Repl. 2010-2012
Total Replenishment Target Level (USD million)	1 000
Average Annual Replenishment Level (USD million)	333
Average Annual POW (USD million)	856
Maximum Annual Usage of 5 Years of Future Loan Reflows (%)	100%
Lowest Liquidity Level in Period (USD million)	2 306