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Enabling poor rural people
to overcome poverty

Background note to IFAD's Investment Policy Statement

Note to Executive Board representatives

Focal points:

Technical questions:

Iain Kellet
Chief Finance Officer and Head,
Financial Operations Department
Tel.: +39 06 5459 2403
e-mail: i.kellet@ifad.org

Munehiko Joya
Director and Treasurer
Treasury Services Division
Tel.: +39 06 5459 2551
e-mail: m.joya@ifad.org

Dispatch of documentation:

Deirdre McGrenra
Governing Bodies Officer
Tel.: +39 06 5459 2374
e-mail: gb_office@ifad.org

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For: **Review**

Background note to IFAD's Investment Policy Statement

I. Introduction

1. This document takes into consideration feedback received at the 117th Audit Committee meeting on document AC 2010/117/R.8 and at the Executive Board informal seminar held on this subject on 16 March 2011. The information included in this document is based on financial market conditions and data and on IFAD's investment portfolio and financial flows as of 31 December 2010.
2. The previous review of IFAD's investment policy was conducted in 2006 under a technical assistance agreement with the World Bank. It concluded that the policy's return and risk characteristics were in line with IFAD's then-specified return target of 3.5 per cent.
3. The financial crisis of 2008/2009 caused IFAD to review its investment policy in the context of changing financial market assumptions and taking into consideration IFAD's updated projections for its financial flows and resources.
4. In conducting this most recent review, IFAD was supported by Ortec Finance,¹ a Dutch consulting company specialized in asset/liability management (ALM) modelling, which provided advanced technical modelling support and supplemented the internal review work. The findings of the review indicate that IFAD should adjust its investment policy in order to better manage risks and preserve the Fund's ability to meet its investment objectives.
5. IFAD has simultaneously reviewed the validity of its minimum liquidity requirement, which should be considered an integral building block of the investment policy. The current liquidity policy, or minimum liquidity requirement, was established² for the first time in the period of the Seventh Replenishment of IFAD's Resources (2007-2009).
6. In response to guidance received at the informal seminar held on 16 March 2011, IFAD will present an Investment Policy Statement (IPS) to the Executive Board at its 103rd Session in September 2011 for approval, which incorporates proposed changes to IFAD's investment policy. Moreover, pursuant to Financial Regulation XIII, investment guidelines will be issued by the President based on the framework set by the IPS.
7. The IPS provides the framework for the management of investments of the Fund and has been prepared following best practices in the investment management industry.³ Accordingly, the components of the IPS outline the governance of investments, the objectives for return and risk, criteria for performance and risk management.

II. Rational behind IFAD's Investment Policy Statement

8. IFAD's investment portfolio has performed well in recent years. Nevertheless, there has been a downward performance trend and outlook for the portfolio due to several developments expected to have a negative impact on fixed-income investments, some of which are detailed below:

¹ Ortec Finance, established in 1981, is a global provider of technology and advisory services for risk and return management. It designs, builds and applies solutions for asset/liability management, performance measurement and risk attribution. Clients include: pension funds, insurers, asset managers, housing corporations and financial planners.

² In response to the Report on the Consultation on the Seventh Replenishment of IFAD's Resources and resolution GC 29/L.4, the current liquidity policy was approved at the eighty-ninth session of the Executive Board.

³ CFA Institute, Elements of an Investment Policy Statement for Institutional Investors, ISBN 987-0-938367-32-1 (May 2010), www.cfapubs.org/doi/abs/10.2469/ccb.v2010.n13.1.

- (a) Record low interest rates in many developed markets.
 - (b) Rising inflationary pressures due to projected continuing increases in energy and food prices, which are supported by accommodative monetary policies.
 - (c) Monetary policies are expected to be tightened to contain inflationary pressures. Interest rate hikes (or expectations thereof) will cause losses on fixed-income investments as their prices fall.
 - (d) Rising government indebtedness. The previously assumed risk-free status of high-quality sovereign debt is becoming more questionable, with credit rating cuts and potential debt restructurings also occurring in some developed markets, adding to market price volatility and loss possibilities.
9. The above negative circumstances for fixed-income instruments already caused interest rates to temporarily rise around year-end 2010 and the circumstances remain valid.
 10. Moreover, recent financial-crisis awareness of so-called financial bubbles and tail-risk events has also risen in the fixed-income area and is leading investors to place greater emphasis on risk management in the investment decision-making process and to allow for greater flexibility and responsiveness. This implies that an investment policy and its strategic asset allocation (SAA)⁴ should be frequently monitored, with potential adjustments to the SAA being made on a risk-adjusted basis. In light of IFAD's investment objectives as laid out in the Financial Regulations of IFAD – capital preservation, liquidity, and return maximization within these two parameters – an investment policy approach driven by risk management is most appropriate.
 11. Due to the negative fixed-income outlook, IFAD's current investment portfolio is exposed to very weak performance, especially on a short-term horizon, according to the advanced risk and return simulations done for the review.
 12. In conjunction with reviewing its investment policy, IFAD conducted a comparison with the asset allocations of other international financial institutions (IFIs). Their investment profiles, similar to IFAD's, are conservative, although some institutions have more diversified allocations through exposures to corporate bonds, sovereign emerging market debt, equities and securities lending/repurchase agreements. Some IFIs have confirmed that they are reviewing their investment policies in view of current approaches to the adverse market conditions for highly rated fixed-income instruments.
 13. The negative outlook for fixed-income investments, together with a greater need for risk-monitoring and flexibility, have led IFAD to make the following proposals:
 - (i) More diversified asset allocation within the fixed-income universe;
 - (ii) Adoption of a risk-budgeting framework as the basis for more dynamic asset allocation.

Proposed diversification

14. The projected negative impact could be reduced by diversifying the Fund's fixed-income investments more broadly and thereby increasing the benefits from the lower correlation between diverse fixed-income investments.
15. The following changes are proposed to increase diversification in IFAD's investments (summarized in the table below):
 - (a) For sovereign or sovereign-guaranteed bonds: expanding the current minimum credit floor from AA- to BBB- rated securities that are part of the investment grade universe (i.e. no junk bond characteristics). Diversification

⁴ SAA refers to the weighted allocations to different investment asset classes. It is established as part of an investment policy in order to achieve the investment objectives.

would be enhanced through the lower correlation between sovereigns with different credit quality ratings.

- (b) For corporate bonds: expanding the credit floor from AA- to A- would meaningfully yet prudently add to diversification by reducing exposure to financial-sector corporate bonds, which heavily dominate (by 70 per cent) the AA- rated corporate bonds universe.

Current asset allocation^a and proposed changes

Assets	Current portfolio (percentage)	Medium-term diversified portfolio
Cash	5.6	Potential increase in cash exposure
Hold-to-maturity	16.6	No change foreseen
Global government bonds	40.6	Potential decrease in government bonds exposure
Emerging-market government bonds	-	Addition of some exposure to emerging-market government bonds
Diversified fixed interests	16.7	Potential increase in corporate bonds exposure
Inflation-indexed bonds	20.5	No change foreseen

^a As at 30 June 2011.

16. Under this diversification, the credit floor rating would not be the sole criterion used to select eligible assets. Indeed, this would be supported by an analysis of fundamentals for each asset under consideration.
17. IFAD's review suggests that a better-diversified portfolio, which would increase allocations to corporate bonds and to sovereign investment-grade emerging markets, would improve performance and reduce the probability of a negative return over a three-year horizon. This is a preferred scenario, which would be more likely to counter inflation and ensure capital preservation relative to IFAD's current portfolio.

Proposed risk-budgeting framework

18. To date, IFAD measures, monitors and manages investment risks through strategic asset allocations that are fixed in percentage terms and held steady throughout time. This static model, based on long-term asset class characteristics, works in periods of relatively calm market conditions, but the investment risks become harder to manage during periods of extreme market stress, such as the 2008/09 financial crisis. External investment managers may adjust positions within their mandates, but these changes are made in "silos" to reflect their subjective views about risk and return.
19. Under the risk-budgeting framework, the management of investment risks will be brought to the front line. It is a process of managing the investment portfolio more dynamically in relation to its target risks, whereby an investor establishes acceptable risk levels as a "budget" (degree of deviation from the benchmark return) across asset classes through key risk factors and indicators. As markets evolve, necessary adjustments are made to the investment portfolio composition to stay within the established risk budget.
20. Risk budgeting requires a constant and systematic assessment of changes in risk levels. A consequence of this approach should be that investment risk management is enhanced and capital preservation is all the more assured in periods of extreme market stress.

III. Implementation plan

21. Delivering the proposed IPS will require deepening IFAD's internal capacity and broadening the network of service providers currently hired to assist in managing the investment portfolio. An outline follows of the main implementation steps and

capacity-building planned for implementation of IFAD's IPS. The workflow is illustrated in greater detail in the annex.

- (a) Initiate design of a risk-budgeting framework as the basis for dynamic asset allocation – through procuring an external service provider of risk management services and aligning internal decision-making bodies and processes to the approved IPS;
- (b) Build the capacity of the treasury services division in charge of risk and investment management and assess potential additional staff resource requirements;
- (c) Present investment guidelines in line with the IPS, including benchmarks for more-diversified assets, for the approval of IFAD's President;
- (d) Review service requirements with IFAD's global custodian bank based on the new investment guidelines;
- (e) Procure specialized investment managers for new diversified assets;
- (f) Implement the new risk-budgeting framework prior to funding new diversified assets; and
- (g) Report on a quarterly basis to the Executive Board on process implementation, monitoring of risks versus established risk tolerance levels, and any adjustments to the investment portfolio composition.

IPS implementation workflow as at 31 July 2011

