Financial Risks and Investment Management of Trust Funds

Michael Koch
Director,
Financial Management (CFPFM)
Overview

1. Financial Risks in Trust Fund Programs
2. Area of Focus: Currency Risk
3. Investment Management of Trust Fund Liquid Assets
The World Bank - as trustee – manages funds from donors until disbursed to recipients

Trust Fund financial risks are managed by the World Bank within a value chain that includes monitoring, reporting, systems and controls
- CFP carries out regular, comprehensive risk assessments for Trust Funds
- For Q4 of fiscal year 2011, a new Trust Fund financial risk section will be added to the Board’s Quarterly Risk Report
- Significant investment in Trust Fund information systems and security

A recent internal audit of Trust Fund Financial Risk Management was rated “Satisfactory”
- The auditors suggested that Management raise the issue of Currency Risk with Trust Fund donors

Management is also updating the Investment Strategy for Trust Funds
Four Primary Financial Risks in Trust Fund Programs

I. Liquidity Risk
- On aggregate, Trust Funds administered by the WB hold some $24.9 billion in liquidity
- Liquidity covers more than 2 years of Trust Fund disbursements
- **Liquidity risk** is considered low, even though liquidity held by individual funds is not fungible across other funds
- **Risk mitigation:** Daily cash flow monitoring, aided by timely donor contributions

II. Investment Risk
- Donor contributions have outpaced grant disbursements
- The WB invests these resources in the capital markets until funds are disbursed
- **Investment risk** arises from changes in market interest rates and credit spreads, causing changes in bond prices and yields
- **Risk mitigation:** Conservative risk limits, combined with tailored investment horizons

III. Donor Funding Risk
- Some donors provide funding over time
- If funding is delayed, or reduced, grant recipients may receive less resources than expected
- **Donor funding risk** arises if the WB approves grants before donor contributions have been paid in
- **Risk mitigation:** Best practice is to limit grant commitments to funds already received from donors

IV. Currency Risk
- Most donors provide funding in currencies other than US dollars
- Most recipient grants are committed in USD. This results in a currency mis-match.
- **Currency exposure** arises if the WB approves grants before donor contributions have been paid & converted
- **Risk mitigation:** Limiting grants to 85% of future donor contributions, until funds are paid in
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Nature of Currency Risks in Trust Funds

- More than 200 donors to Trust Funds, from 77 countries, providing funding in 30 different currencies

- Risks inherently result from the **structural currency mis-match** between donor contributions and grant commitments for a Trust Fund

- **Actual currency exposure** arises if the World Bank approves grants before donor contributions have been paid in & converted into the required currency for a Trust Fund

- This is an **exposure of grant recipients**, not of donors nor the World Bank
  
  - If the donor currency loses value against the Trust Fund’s commitment currency, before contributions have been paid in by the donor, then grant recipients may receive less funding than expected
Currencies of Donor Contributions and Grant Commitments

A Structural Currency Mis-match

Donor Contributions: 10% in USD

- USD 10%
- EUR 32%
- GBP 33%
- JPY 8%
- NOK 8%
- SEK 2%
- CAD 1%
- AUD 4%
- Other 2%

Grant Commitments: 95% in USD

- USD 95%
- EUR 4%
- Other 1%

Note: Data as of March 31, 2011. Shown are aggregate portfolio amounts; individual Trust Fund contribution/disbursement profiles may differ.
Managing Currency Risk

What the World Bank Does:
Temporarily Limiting Grant Commitments Until Donor Funds are Paid in

- Extending grants against unpaid donor funds?
  - No
  - Yes

- Does donor currency differ from grant currency?
  - No
  - Yes

- No currency exposure (WB best practice)
  - Before donor funds are paid in
    - $15 currency buffer
  - After donor funds are paid in
    - $100 available for grants

- Currency exposure for recipients
  - Example: $100 of donor contributions
Managing Currency Risk (contd.)

What the *World Bank* Does: Current Practice vs. Alternate Approach

**Current Practice**

- Before donor funds are paid in
  - $15 currency buffer
  - $85 available for grants
- After donor funds are paid in
  - $100 available for grants

- Uniform 85% Commitment Limit
- Effectiveness confirmed by historical testing of currency volatility
- Easy to implement and communicate

**Alternate Approach**

- $25 buffer
- $75 available for grants
- Donor currency with high volatility

- $5 buffer
- $95 available for grants
- $100 available for grants
- Donor currency with low volatility

- Commitment Limit depends on each donor
- Strengthens currency risk management
- Could result in high currency buffers
- Complex to implement and communicate
What *Donors* Can Do: Contributing in the Required Currency for Grant Commitments

- **Extending grants against unpaid donor funds?**
  - No: No currency exposure
  - Yes: Does donor currency differ from grant currency?
    - No: No currency exposure (currency match)
    - Yes: Currency exposure for recipients

**Trust Fund A**
- Donors pledge in **US Dollars**
- Grants are in **US Dollars**

**Trust Fund B**
- Donors pledge in **Euros**
- Grants are in **Euros**

- Eliminates currency risk
- No Currency Buffer necessary
- Donors could buy own FX hedge
- IBRD could intermediate FX hedge
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Last Update of the Trust Fund Investment Strategy in November 2004

Stable investment performance between 2005 and 2010 - The current strategy has served donors well
- Avg. investment return of 3.9% per year over FY05-10, while minimizing risks
- USD 534 million of incremental investment income since February 2005

Motivation for new review at this time
- Substantial growth of the Trust Fund liquid asset portfolio
- Emergence of FIFs with large liquidity balances, reliance on investment income
- Challenging market environment after the global financial crisis

Updated Trust Fund Investment Strategy is scheduled for review by the World Bank Audit Committee on June 22, 2011
Investment Objectives and Risk Limits

- Objective: Optimize investment returns subject to conservative risk tolerances and liquidity requirements

- Preservation of capital of Trust Funds seen as the dominant objective
  - Reflects perceived donor sensitivity to principal losses

- Individual funds have different horizons and risk tolerances, captured in the tranche structure of the Trust Fund investment pool:
  - Tranche 0: Cash
  - Tranche 1: 1-year investment horizon
  - Tranche 2: 3-year investment horizon
  - Tranche 3: IFFIIm investments

- Tranches 1 & 2 are managed on a constant risk basis: Limiting the risk of reporting a negative return to 1% over the respective investment horizon (i.e. reporting a positive return 99 times out of 100)
Growth of Trust Fund Investments

By Type of Trust Fund (in USD equiv. million, past decade)

By Trust Fund Tranche (in USD equiv. million, since updated TF investment strategy)
Performance follows market yields; Tranche 2 (3-year horizon) has added further value.
Market Environment

- The current low-yield environment leads to a higher likelihood of rising market yields.
- This increases the risk of mark-downs of fixed income securities, and of incurring low or negative returns.

US Treasury 1-3 Year Index – Risk and Returns, 1995 to 2011
## Summary of Investment Strategy Recommendations

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| **Investment Objectives, Risk Constraints, Governance** | Governance and ongoing oversight should be further strengthened, given the continued growth of the Trust Fund investment portfolio.                                                                                       | • Maintain current investment objectives and risk constraints  
• Create a new Trust Fund Investment Committee composed Bank unit directors, reporting to Bank Group CFO                                                                                                    |
| **Tranche Structure**                    | For some of the largest funds and programs, their high and rising liquidity levels suggest a longer investment horizon than currently offered.                                                                                        | • Establish a new 5-year investment tranche, managed to a 1% risk of reporting a negative return over the investment horizon                                                                                       |
| **Asset Mix**                            | The Trust Fund portfolio is exposed to possible mark-downs in fixed-income instruments, as market interest rates are expected to rise from historically low levels.  
Large funds will benefit from more investment options and further diversification of asset classes.                                                                                                           | • Add a low percentage of equities in the new 5-year tranche, with well-defined eligibility constraints for participating funds                                                                                     |