ADAPTATION FUND

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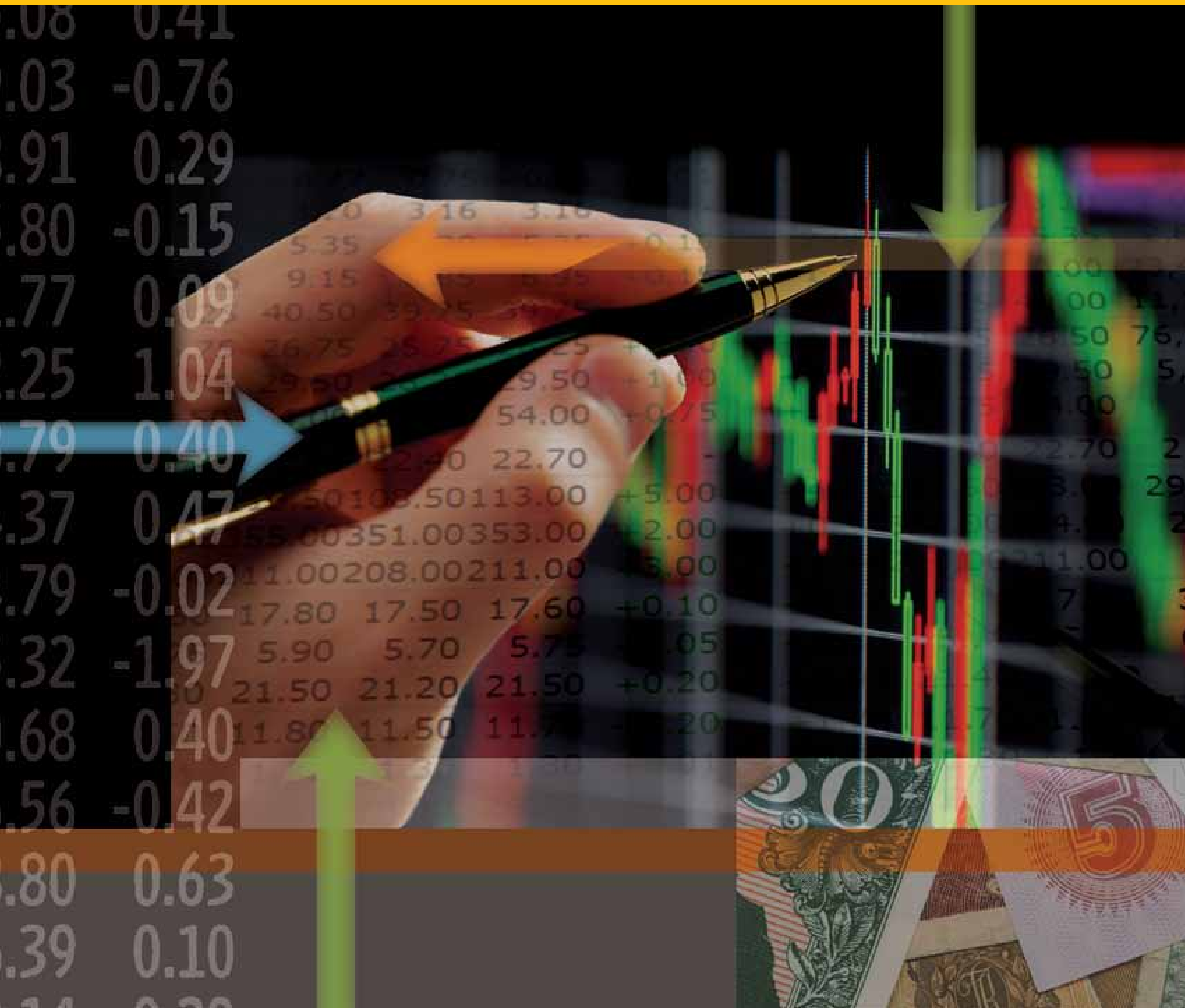
Adaptation Fund Board
Eighth Meeting
Bonn, 14 March, 2012

INVESTMENT MANAGEMENT OF DONOR FUNDS (THE WORLD BANK GROUP)

Investment Management of Donor Funds

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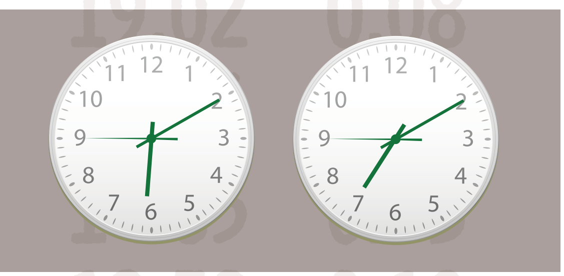

Tokyo Sydney

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The World Bank seeks to prudently add value by expanding the variety of investment strategies and products available to cater to the varying requirements of its donors and enhance investment returns.

Introduction

For more than five decades, donor governments have been entrusting the World Bank with funding to promote economic growth and reduce poverty in developing countries. Today, donors provide more than $20 billion per year to the different funding mechanisms administered by the World Bank. These include the International Development Association (IDA, the World Bank's fund for the poorest), trust funds managed by the World Bank Group, as well as Financial Intermediary Funds where the World Bank acts as a financial manager for international development initiatives.

After donors pay in their contributions, the World Bank will invest these resources in the international capital markets until funds are disbursed to final recipients for development projects. Such investment services aim to preserve donor funds and enhance their value. With the continuous growth of donor funding over time, and increasing donor contributions for multi-year development programs, the volume of liquid assets held by IDA and Trust Funds together has reached $48 billion as of March 2011.

This brochure provides information on the World Bank's asset management services for donors. The World Bank Treasury has developed substantial expertise in asset and liability management and achieved a global reputation as a prudent and innovative borrower, investor and risk manager. In managing donor funds, the World Bank follows a well-defined investment process, applying a conservative risk approach with ongoing oversight through the World Bank's financial governance structure.

Sound investment management is an integral part of the value process to ensure the availability and appropriate use of donor funds for their intended purposes. As such, preservation of capital has been the dominant objective in investing donor assets. The World Bank seeks to prudently add value by expanding the variety of investment strategies and products available to cater to the varying requirements of its donors and enhance investment returns.

The investment portfolios of IDA and Trust Funds administered by the World Bank have seen solid investment performance over the past decade, also weathering well the global financial crisis of 2008/2009. Over and above a typical, passive capital preservation mandate, the incremental investment income for these portfolios is estimated at more than $800 million over the past 5 years.

Beyond prudent investment management and attractive portfolio returns, the World Bank also offers donors an efficient and cost-effective investment platform. This platform allows the World Bank to accommodate funds with varying requirements, while keeping overall administrative costs to a minimum. It costs the World Bank on average 3.5 basis points (0.035%) per year of the assets under management to provide investment services, while commercial asset managers may charge up to 10 times this amount. That results in cost savings for the donor community of some $75–100 million per year, across IDA and Trust Funds, when compared to commercial services.

We hope that you will find this brochure informative and look forward to answering any questions that you may have on the investment management process for donor funds.

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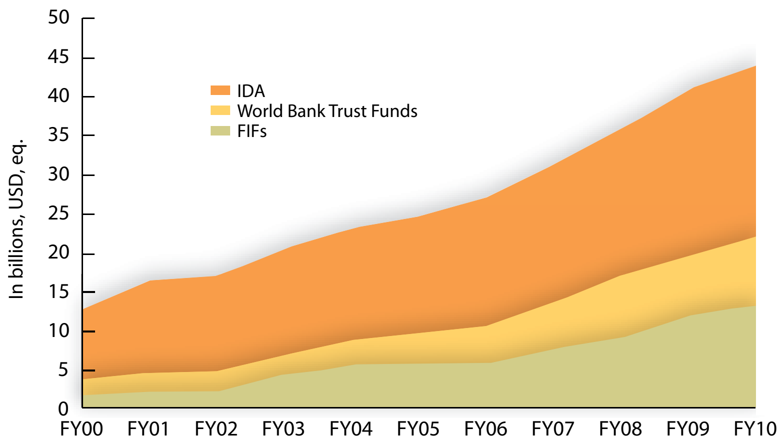
Background

The World Bank has extensive experience in managing and investing donor funds. It has mobilized and managed donor contributions since 1960 when the International Development Association (IDA) was created to support the poorest countries through interest free and long maturity loans. IDA's investment portfolio has doubled in size over the past decade, to reach $23 billion as of March 2011. Much of this growth is attributed to the rising volume of donor contributions under the IDA15 replenishment round which covers the World Bank's fiscal years 2009-2011. During this period, IDA's disbursements to client countries have more than doubled to some $12 billion per year, while its new approvals for credits and grants have increased to some $15 billion per year.

Since the 1980s, donors have also provided bilateral aid resources and other contributions through trust funds administered by the World Bank. In particular over the past decade, donors have engaged the World Bank as trustee for Financial Intermediary Funds (FIFs). In this function, the World Bank takes on different financial management and advisory roles, while project implementation and oversight in developing countries is carried out by donor agencies or other entities.

Donor assets managed by the World Bank for trust funds and FIFs are commingled for investment purposes in the Trust Funds investment portfolio. Over the last ten years, the combined Trust Funds portfolio has seen substantial growth with the value of liquid assets increasing five-fold to reach $25 billion as of March 2011. The growth reflects the continuous increase in the number and volume of active trust funds and FIFs administered by the World Bank. The Trust Funds universe is currently composed of around 5,000 disbursing grant accounts that make up some 1,000 separate trust funds and FIFs. Their combined disbursements and transfers are close to $10 billion per year.

Donor Funds Under Management, Fiscal Years 2000–2010



After donors pay in their contributions, the World Bank will invest these resources in the international capital markets until funds are disbursed to final recipients for development projects. Such investment services aim to preserve donor funds and enhance their value. With the continuous growth of donor funding over time, the combined volume of investment assets held by IDA, trust funds and FIFs together has reached $48 billion as of March 2011. Timing mismatches between donor contributions and disbursements, as well as increasing donor contribution payments for multi-year development programs, such as in the case of "accelerated" donor contributions for IDA or other, replenishment-based trust funds, have contributed to the rising volume of liquid assets held for investment.

Both IDA and trust funds administered by the World Bank receive donor funds in multiple currencies. Upon receipt by the World Bank, these funds are typically invested in the currency of eventual disbursements to recipients in developing countries. As such, IDA's investment portfolio is held mostly in the constituent currencies of Special Drawing Rights (SDR, a currency basket which includes US dollars, Euros, Pound Sterling and Japanese Yen), while the Trust Funds investment portfolio is held primarily in US dollars.

The Investment Management Process for Donor Funds

The investment of donor funds in the international capital markets follows a well-defined process, involving different stages of review, approval and ongoing monitoring and controls. The process starts by establishing an appropriate asset management strategy for the funds to be invested. This strategy is guided by a defined set of investment objectives and risk tolerance limits, to be reviewed and approved by appropriate departments and financial committees. To formulate the investment strategy for investment assets held by IDA and Trust Funds, the World Bank Treasury develops a strategic asset allocation (SAA) which is designed to achieve the investment objectives and meet the specified risk tolerance.

The SAA process identifies the suitable types of investment instruments (asset classes) and their weights in the investment portfolio, and determines the appropriate portfolio benchmark for each asset class. These benchmarks closely guide the ultimate investments which are established through approved counterparties in the capital markets, based on investment guidelines that limit market risk (such as interest rate risk) and credit exposure. Credit limits for holding funds for investment with commercial banks are determined by the World Bank's Corporate Finance Department, an independent group which reports separately to the World Bank Group's Chief Financial Officer. Ongoing risk measurement and performance reporting for the IDA and Trust Funds investment portfolios are conducted on a daily basis by a separate department within the Treasury. Furthermore, an independent compliance unit measures compliance with the approved investment guidelines, using pre-trade and post-trade compliance systems.

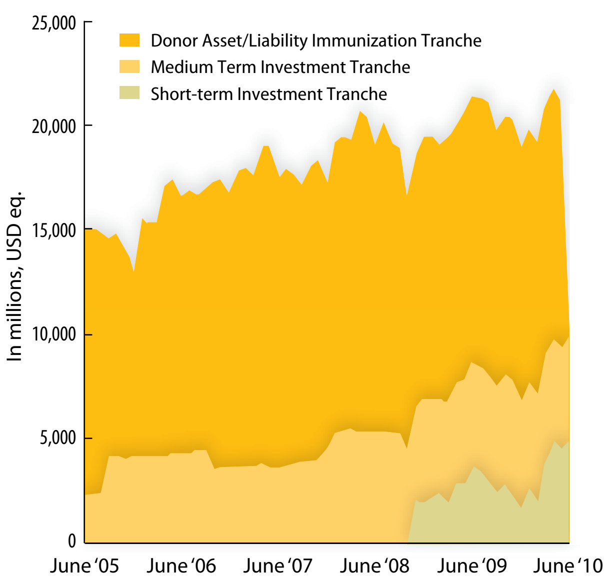
Investment Objectives and Strategy

The investment assets of IDA and Trust Funds are separated into investment tranches with different investment objectives, investment horizons and risk tolerances, based on the nature of the cash flows in each portfolio. The World Bank Treasury develops a separate strategic asset allocation for each investment tranche to achieve these investment objectives. Preservation of capital is seen as the dominant investment objective, reflecting perceived donor sensitivity to any potential losses of capital that could results from adverse movements in the international capital markets. Consequently, investments for IDA and Trust Funds are managed to conservative overall risk tolerance parameters. (See also technical box on "Defining Investment Objectives".)

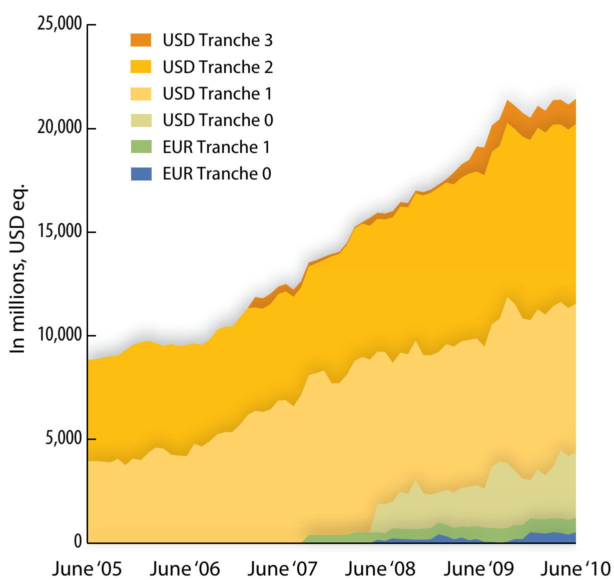
IDA's investment assets are invested in three separate tranches. The majority of IDA's investment assets result from contributions that are paid in by donors before IDA requires these funds for disbursement to its recipients of credits and grants in developing countries. Donors typically elect to "accelerate" their contributions for either budgetary purposes, in order to receive payment discounts, or as a way of providing additional resources to IDA. IDA invests these donor funds as a separate tranche classified as Donor Asset and Liability Immunization, where IDA is in essence providing an asset management service to its donors. In addition, IDA maintains a Medium Term Investment tranche with a 3-year investment horizon, aimed to enhance investment income on IDA's core liquidity, as well as a Short Term Investment Tranche for IDA's working capital needs.

The investment assets held in the investment pool for Trust Funds are also separated into distinct tranches. This tranching structure is reflective of the fact that individual funds within the overall portfolio may have different investment horizons and also risk tolerances. The investment objective of each

IDA Investment Assets by Tranche, Fiscal Years 2005–2010



Trust Funds Investment Assets by Tranche, Fiscal Years 2005–2010



tranche is to optimize investment income subject to the preservation of capital and the liquidity requirements of the underlying funds. Each investment tranche represents a different model portfolio to achieve this objective over the distinct investment horizons, which range from daily up to three years. The World Bank is currently developing an additional model portfolio for trust funds so as to cater to those funds which may have an even longer investment horizon of up to five years. All funds within the Trust Funds pool are reviewed periodically with a view to ensure that they are allocated to the most suitable investment tranche, based on multi-year cash flow projections for each fund.

Defining Investment Objectives: Liability Immunization and Return Optimization

An institutional investment portfolio, such as that for IDA, may hold investment assets for the main purpose of making future payments, for example for transfers to borrowers on credits which have been approved already and for which liquid funds are being held for disbursement. The primary investment purpose is therefore to hold assets in relation to known, future liabilities. The future stream of the expected cash outflows has an average maturity associated with it, also called portfolio duration, which is an indication of the interest rate sensitivity of these cash flows. Under asset-liability immunization, the duration target for the investment portfolio's benchmark is set in a deterministic way in order to match the weighted average maturity of the projected liabilities.

For IDA's investment Tranche 1 (the Donor Asset and Liability Management tranche), the portfolio benchmark may have a relatively long duration in order to match the profile of IDA's projected disbursements. Since a typical IDA disbursement cycle extends up to 10 years, IDA's portfolio duration for Tranche 1 will be relatively long. In this case, the long asset duration is the lowest risk choice in an asset-liability management context.

However, when future liabilities are uncertain, a classic approach of asset-liability immunization may not be feasible. This is the case for IDA's investment Tranche 2 (the Medium Term Investment tranche) and also the Trust Funds investment portfolio. Here, portfolio benchmarks are set dynamically to achieve return optimization, subject to a specific risk tolerance level. Risk tolerance limits for these portfolios are typically expressed in terms of capital preservation: They are specified as a near-negligible likelihood of a loss of principal which is estimated over a pre-defined investment horizon, based on financial models. The investment horizon itself is chosen based on the nature of the funds under management and the length of time that funds are expected to be stable and available for investment purposes.

The portfolio benchmark of a return-optimization tranche is dynamic because conditions in the capital markets may change. For example, changes in market interest rates will have implications for the range of investment alternatives that will satisfy the capital preservation constraint at any given point in time.

Investment Sectors

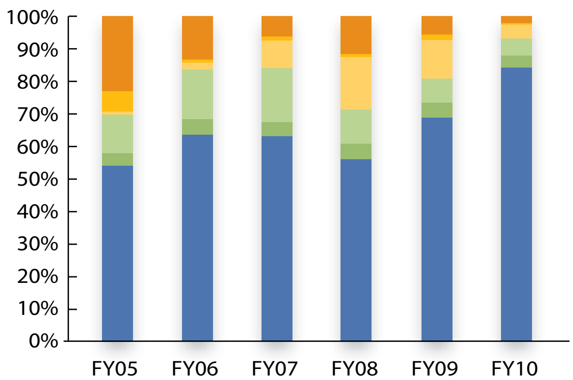
The strategic asset allocation for each investment tranche is implemented by selecting suitable benchmarks for the identified investment sectors. The Investment Guidelines for the IDA and Trust Funds investment portfolios specify the allowed range of instruments, for each investment sector, within the high grade fixed income category (such as government bonds) as well as money market securities (such as short-term investments with commercial banks).

Currently, these instruments include securities that are rated AAA to AA- and are issued by sovereign governments, government agencies, as well as multilateral and other official institutions. In addition, allowable instruments include asset-backed and agency-guaranteed mortgage-backed securities, provided that these are rated AAA, as well as swaps and a range of other derivative instruments.

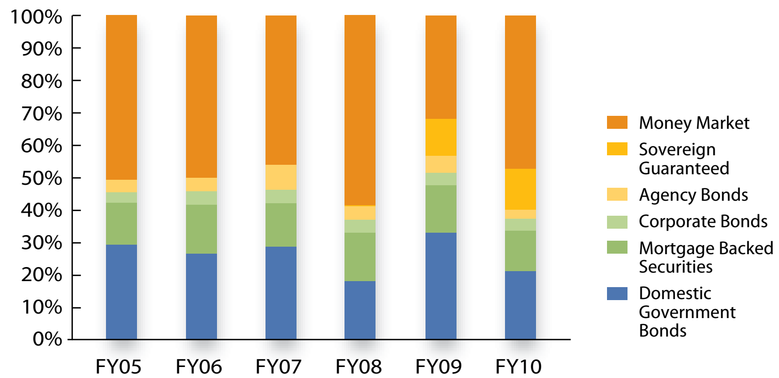
Investment Sectors for IDA and Trust Funds Portfolios

Asset Class	Asset Description
Domestic Government Securities	Marketable bonds, notes or other obligations issued or unconditionally guaranteed by the government of a country in its own domestic currency and approved by the World Bank's Credit Committee.
Mortgage-backed Securities (MBS)	US Agency-guaranteed residential mortgage-backed securities, including fixed-rate pass-throughs, adjustable rate mortgages (ARMs), interest-only (IO) and principal-only (PO) strips, and collateralized mortgage obligations (CMOs). Commercial Mortgage Backed Securities (CMBS) and non-agency MBS are not included.
AAA Corporate Securities (incl. Asset Backed Securities)	AAA-rated asset-backed securities (ABS), backed by student loans, auto and credit card receivables, public sector loans or prime first lien residential mortgages and domiciled in an eligible country, and any other AAA-rated obligations of a corporate entity.
Agency/ Sovereign/ Government guaranteed Securities	Marketable bonds, notes or other obligations rated at least AA- issued by a government agency, supranational institution or local authority domiciled in an eligible country as well as corporate debt guaranteed by the government of eligible countries.
Money Market Instruments/ Financial Institutions Securities	Time deposits, certificates of deposit, reverse repurchase agreements and other obligations issued or unconditionally guaranteed by a bank or other financial institution domiciled in an eligible country, whose senior debt securities are rated at least A- and maturing in 3 months or less.

Asset Composition of the IDA Portfolio, Fiscal Years 2005–2010



Asset Composition of the Trust Funds Portfolio, Fiscal Years 2005–2010

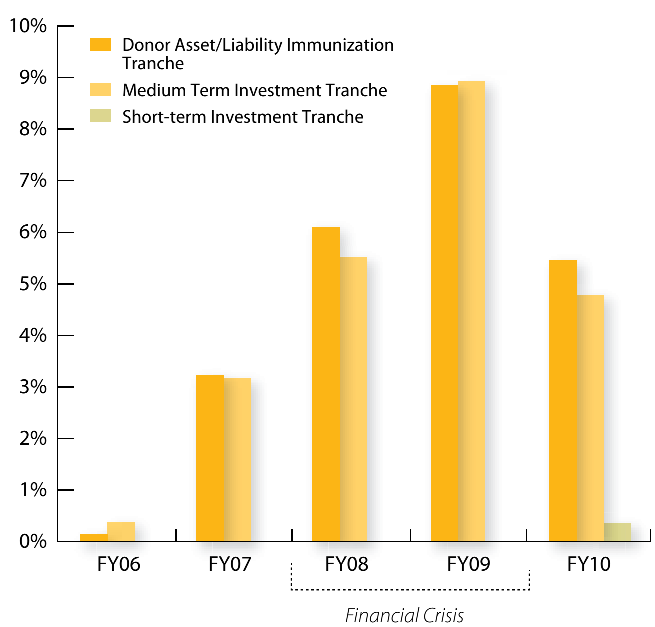


Investment Performance

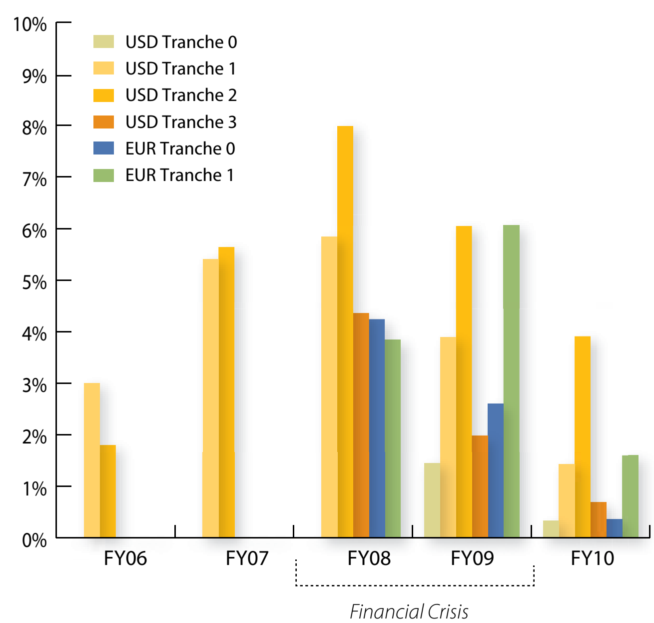
The IDA and Trust Funds investment portfolios have seen solid performance over the past 5 years, mostly driven by declining US dollar interest rates during the financial crisis in 2008 and 2009, resulting in increases in market valuations for high-grade bonds. When interest rates decrease in major markets, bonds providing a fixed coupon income will increase in market value, and this will increase the total return from coupon income plus market price changes from holding these bonds (see also technical box on "Impact of Market Yields on Fixed Income Portfolios"). Conversely, rising market yields brought down total investment returns during fiscal year 2010, with a low return outlook for fiscal year 2011.

Over the past five year period, the World Bank has been able to enhance investment returns over and above the primary capital preservation objective for IDA and Trust Funds. This was achieved through an improved strategic asset allocation as well as active portfolio management by the World Bank Treasury. Compared to a constant benchmark index of holding US Treasury securities in the 1–3 year range plus cash deposits (i.e., a typical benchmark combination for conservative portfolios), the investment portfolios for IDA and Trust Funds have been able to earn additional investment income. For the past five years, this incremental income is estimated at around $580 million for the Trust Funds portfolio and about $240 million for IDA's Medium Term Investment tranche.

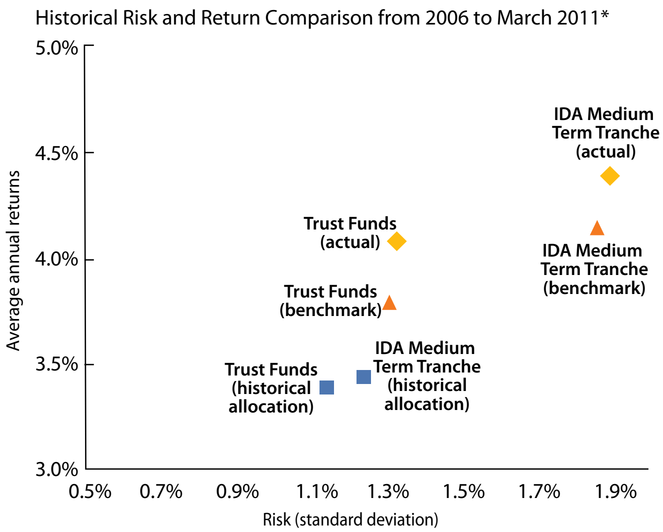
Portfolio Returns of IDA Tranches, Fiscal Years 2006–2010



Portfolio Returns of Trust Funds Tranches, Fiscal Years 2006–2010



Value Added from Active Management and Strategic Asset Allocation

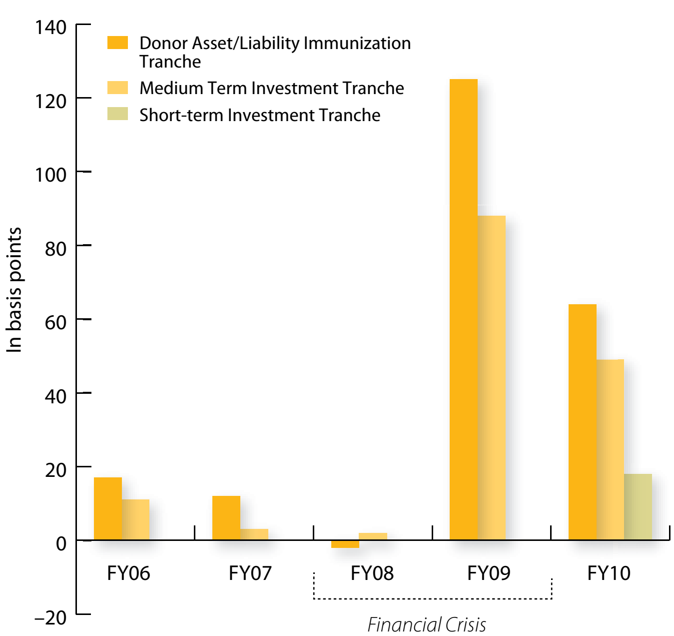


Estimated Dollar Value Added, April 2006 to March 2011 (USD mm)*

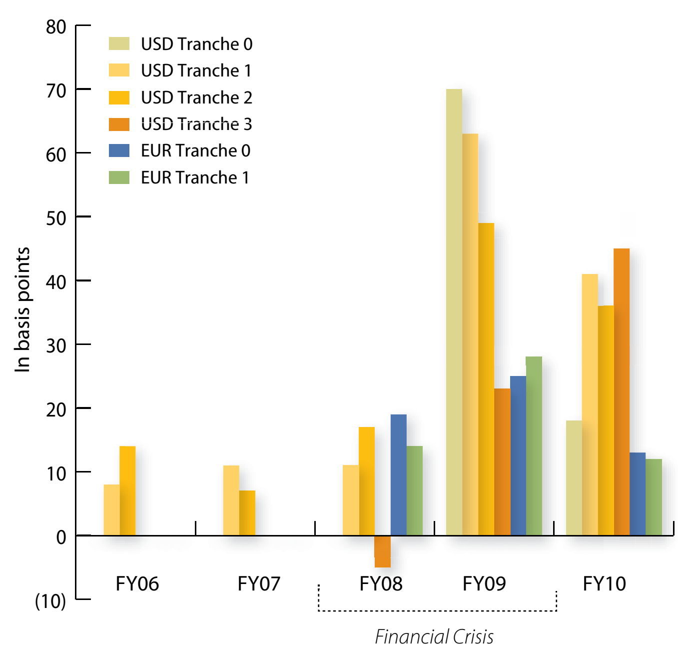
	from SAA	from Active Management	Total
IDA—Medium Term Investment Tranche	180	63	243
Trust Funds (USD)	332	252	584

*Historical allocation is based on a combination of cash and Government 1–3 year bond indices, in SDRs for IDA and in USD for Trust Funds. Dollar value added is measured as the difference between actual portfolio returns and estimated returns of the historical allocation.

Excess Returns of IDA Tranches vs. Benchmarks, Fiscal Years 2006–2010



Excess Returns of Trust Funds Tranches vs. Benchmarks, Fiscal Years 2006–2010



Asset Management During the Global Financial Crisis

The World Bank took several steps to further safeguard donor assets and preserve their investment performance during the global financial crisis of 2008-2009. These included but were not limited to:

- Reducing the duration of the portfolio to limit sensitivity to interest rate risk
- Reducing exposure to financial institutions most adversely affected by the crisis
- Regularly reviewing the portfolio to ensure adherence to credit rating constraints, as many institutions experienced credit rating downgrades
- Limiting trading to the strongest counterparties to minimize risk due to counterparty failure
- Strengthening collateral policies and procedures to reduce counterparty exposure

Governance and Oversight

Institutional oversight over donor funded programs is provided by the World Bank's Executive Directors (Board), Committees of the Board such as the Audit Committee, the President of the Institution as well as members of the senior management team. The highest management group to oversee the financial management for IDA and Trust Funds is the Finance Committee, chaired by the Group Chief Financial Officer. A number of sub-committees of the Finance Committee review liquidity and risk management issues on a regular basis.

The World Bank is vested with the responsibility of managing the Trust Funds investment portfolio in a fiduciary capacity. The provisions of the World Bank Board-approved General Investment Authorizations also apply to the investment of World Bank administered trust funds, subject to any specific instructions provided by trust fund donors or governing bodies thereof. This includes, for example, the range of eligible investments for the Trust Funds portfolio.

The investment strategies for IDA and for Trust Funds are periodically reviewed and approved by the appropriate departments and financial committees. The Board's Audit Committee reviews these investment strategies. Regular management discussions take place to assess investment policy and asset allocations while investment returns are reported at least monthly.

The photo includes World Bank staff from the Concessional Finance and Global Partnerships Vice Presidency and the Treasury Vice Presidency. Front row from left: Michael Koch, Carina Pernia Nachnani, Axel van Trotsenburg, John Gandolfo, Vidhya Rustaman, Adam Kobor. Second row from left: Couro Kane-Janus, Myles Brennan, Roberts Grava, Alexandru Valeriu Cebotari, Tapiwa Sikipa.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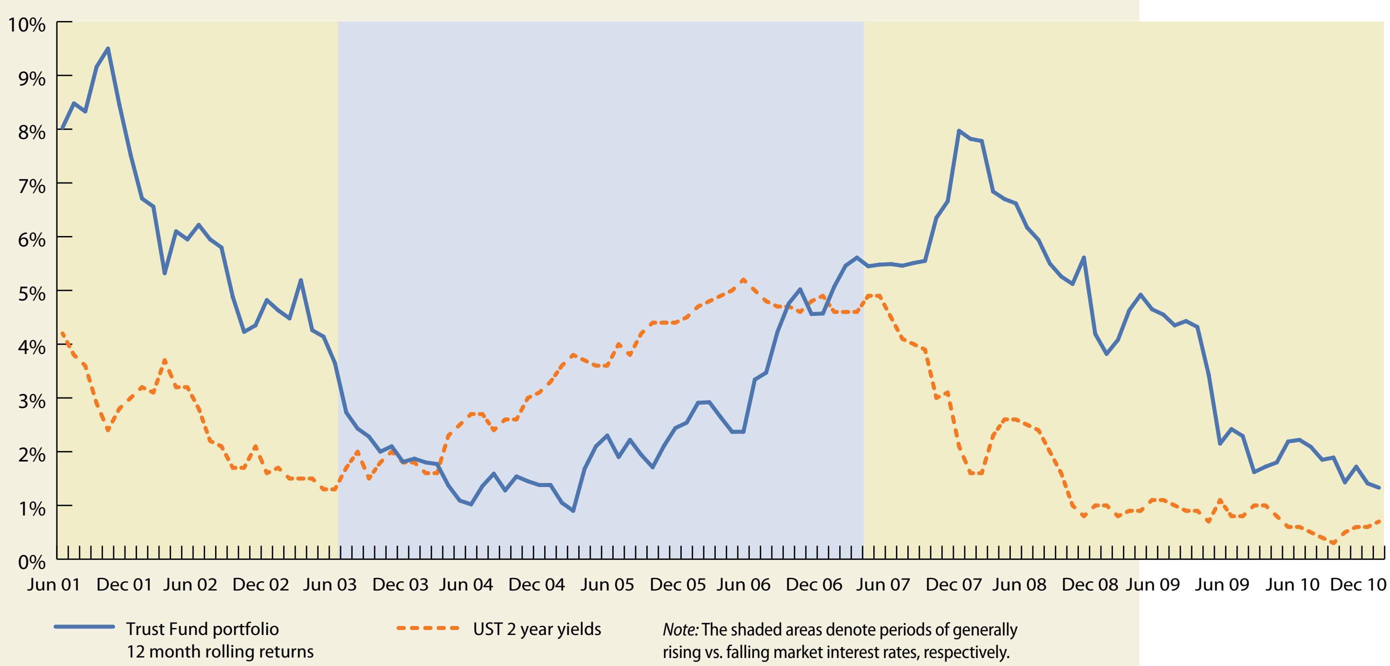
Impact of Market Yields on Fixed Income Portfolios

Investment returns on high-grade bond portfolios consisting of government securities are made up of two components: (i) periodic coupon income at the fixed, contractual interest rate, and (ii) price changes, or change in market value of principal (appreciation or depreciation) on account of changes in interest rates in the capital markets. All other things being equal, an increase in market interest rates results in a depreciation in the value of the original investment in fixed coupon bonds; conversely, a decrease in market interest rates results in an appreciation in the value of the original bond investment. If bonds are held until their final maturity, then there will be no impact from these temporary price changes on the total investment return earned at maturity.

If the second component of investment returns (i.e., price changes) is negative over a given reporting period, and its magnitude exceeds the periodic coupon income, the total investment return over the reporting period can be negative, thus resulting in a decrease in the overall value of the bond investment. While longer maturity bonds typically carry a higher interest rate and thus generate higher coupon income compared to shorter maturity bonds, they are also more susceptible to market price changes as a result of a change in interest rates. Other things being equal, conservative portfolios with limited tolerance for negative returns tend to have shorter portfolio durations; and the lower the level of market interest rates, the shorter will the portfolio duration have to be in order to preclude any reported losses.

The chart below shows the historical rolling 12-month returns of the Trust Funds investment portfolio against the level of yields on US Treasury 2-year bonds as a proxy for the level of US interest rates. The declining interest rates in 2007-2008 were followed by increasing or high investment returns. In contrast, periods of rising rates, such as in 2003-2005, have seen declining or low reported total investment returns. However, during that period, the coupon income, as indicated by the level of yields, was high enough to cushion the negative impact from falling market prices, such that the total return of the investment remained positive. With interest rates near historically low levels in the United States following the global financial crisis since 2009, the World Bank Treasury has taken steps to reduce the sensitivity of the Trust Funds portfolio to the impact of potential future interest rate increases in the markets.



Note: The shaded areas denote periods of generally rising vs. falling market interest rates, respectively.

At a Glance—The Trust Funds Investment Portfolio

The World Bank manages the liquid assets of Trust Funds in a single, commingled investment pool which provides several benefits to its trust fund participants, such as:

- Three model portfolios (in addition to cash) to cater to varying needs and risk preferences of different funds
- Access to a wide variety of investment products and longer maturity investments to enhance returns and investment income over time
- A cost-effective investment platform resulting in very low administrative costs to participants
- Regular review of liquidity needs across funds to optimize investments over the longer term

Investment Sectors for the Trust Funds Portfolio

	Model portfolio 0	**Model portfolio 1**	**Model portfolio 2**	**Model portfolio 3**
	Cash Tranche "Tranche 0"	**Capital preservation over a 1-year horizon "Tranche 1"**	**Capital preservation over a 3-year horizon "Tranche 2"**	**LIBOR based "Tranche 3"**
Investment Objective	Enhance returns subject to ensuring liquidity and timely availability of cash when needed	Maximize returns subject to limiting the probability of negative return with a high confidence level over the specified horizon		Maximize returns subject to 3-month interest rate sensitivity
Strategic Asset Allocation (SAA)/ Benchmark	Overnight cash	Dynamic *(Government bonds and money markets)*	Dynamic *(Government bonds, money markets and US Agency MBS)*	LIBOR based
Currencies		Multi-currency	USD and EUR	USD
Assets under management (US$ mill.)	$4,137	$7,682	$9,068	$1,848
Historical 1-yr rolling return	0.31% (Excess Return 13bps)	0.99% (Excess Return 37bps)	2.61% (Excess Return 31bps)	0.59% (Excess Return 36bps)
Historical 3-yr rolling return		1.88% (Excess Return 46bps)	3.35% (Excess Return 36bps)	1.33% (Excess Return 38bps)

As of March2011

The performance shown here represents past performance and is not a guarantee of future results.

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