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Agenda item 5

WFP INVESTMENT POLICY AND GUIDELINES

*For information**

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NOTE TO THE EXECUTIVE BOARD

This document is submitted to the Executive Board for information.

The Secretariat invites members of the Board who may have questions of a technical nature with regard to this document to contact the WFP staff focal points indicated below, preferably well in advance of the Board's meeting.

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Should you have any questions regarding matters of dispatch of documentation for the Executive Board, please contact Ms C. Panlilio, Administrative Assistant, Conference Servicing Unit (tel.: 066513-2645).

DRAFT DECISION*

The Board takes note of "WFP Investment Policy and Guidelines" (WFP/EB.2/2009/5-F/1).

* This is a draft decision. For the final decision adopted by the Board, please refer to the Decisions and Recommendations document issued at the end of the session.

INTRODUCTION

1. This document is presented in response to a request made by the Board at its 2009 Annual Session for further details of WFP's investment policy and the impact of the global financial crisis.

2. The document sets out:

- the background to WFP's investment management;
- the impact of the global financial crisis on WFP's investments;
- WFP's investment policy and investment guidelines; and
- the measures taken to reduce the risk profile of WFP's investments.

Background

3. The Secretariat assumed responsibility for the management of WFP financial resources in 1999, which led to the development of WFP investment policy and cash and investment management strategies. The management of financial resources is governed by Financial Regulation 11.2 which states: "Monies not required immediately may be invested by the Executive Director, bearing in mind the need for safety, liquidity and profitability". In line with Financial Rule 111.3, the Executive Director issues investment policy circulars from time to time in consultation with outside expertise.

4. The first Executive Director's circular on investment policy came into effect on 30 September 1999. It was amended in the fourth quarter of 2006 on the basis of advice from the World Bank with effect from 1 January 2007; the amendments were reported to the Board in "Report on Changes in WFP's Investment Policy" (WFP/EB.2/2006/5-I/1).

WFP's Investments

5. WFP's cash balances relate to all sources of funding – programme category funds, bilateral operations and trust funds, and General Fund and special accounts. These balances are managed and invested by the Secretariat in line with Financial Regulation 11.2 and Financial Rule 111.3. The investment policy described in this document sets out the principles and parameters for investment of cash that is not required immediately. This is set aside in the liquidity portfolio, which had a market value of US$1.38 billion on 31 August 2009.

6. WFP also sets aside employee benefit funds in a long-term investment portfolio established to meet the liabilities of three employee compensation schemes; its market value was US$119 million on 31 August 2009. Investment of these funds in equities and bonds is carried out under separate long-term investment policy and guided by the recommendations of an asset/liability management study. An updated asset/liability study is currently in progress to ensure that investment policy for these funds takes into account the changed market environment.

7. WFP has a held-to-maturity portfolio of investments in United States Treasury bonds with a market value of US$96 million on 31 August 2009. These securities are held to meet the interest and principal repayments of a once-only long-term loan received in 2000 which is related to the establishment of the Emerging Donors Matching Fund.

Impact of the Global Financial Crisis on WFP's Investments

8. The investment policy in force from the beginning of 2007 strengthened financial risk management through: i) the establishment of risk-tolerance levels; ii) the use of risk limits by the external investment managers; and iii) tighter minimum credit ratings for corporate bonds and asset-backed and mortgage-backed securities. These tools helped mitigate the impact of the global financial crisis, although WFP was not immune to the extreme financial market circumstances that occurred at the end of 2008. The impact on WFP however was limited and temporary, with the losses of 2008 recouped in 2009.

9. The "Audited Annual Accounts, 2008" (WFP/EB.A/2009/6-A/1), which included the report of the External Auditor, reflected negative investment performance resulting from unrealized losses recognized at 31 December 2008. These were mainly in housing-related asset-backed and mortgage-backed securities and some corporate bonds. They were not fully offset by interest income during the calendar year, resulting in the loss of US$9.6 million for the 2008 reporting period. Conditions in financial markets improved during 2009, with positive effects on investment performance: the year-to-date return on investment was US$27 million at 31 August 2009, and many of the unrealized losses recognized in the 2008 financial statements were reversed.

10. Investment performance in the medium term has been positive, with an annual return of 3.3 percent from 2000 to 31 August 2009; interest earned since 2000 is in excess of US$300 million. But in view of the volatility in 2008, the Secretariat has taken steps to limit the risk profile of the investment portfolio: these are described in "Progress Report on the Implementation of the External Auditor's Recommendations" (WFP/EB.A/2009/6-D/1) and in this document.

Updated Investment Policy for WFP's Liquidity Portfolio

11. The updated investment policy and the main elements of the investment guidelines are attached in the Annex. The last review of the investment policy with the World Bank was completed in August 2009.

12. The liquidity portfolio comprises cash balances related to programme category funds, bilateral operations and trust funds, and the General Fund and special accounts. The primary objective of the investment policy for this portfolio is preservation of the value of resources in United States dollar terms. The main considerations for investment management are security of principal, liquidity and rate of return, in line with Financial Regulation 11.2.

13. The investment policy aims to optimize the management of WFP's liquidity portfolio in line with WFP's investment objectives, investment horizons and risk tolerance levels. To make the best use of WFP's risk-bearing capacity and to add value, the liquidity portfolio is separated into three tranches with different investment horizons:

- Portfolio tranche 0 (P0), the working-capital portfolio, accommodates working-capital funds that may be required in the very near future.
- Portfolio tranche 1 (P1), the short-term portfolio, accommodates operational funds with a three-month investment horizon.
- Portfolio tranche 2 (P2), the medium-term portfolio, accommodates funds and reserves with an investment horizon of about one year.

14. The allocation of funds to different tranches is conservative: 48 percent are maintained in P0, 38 percent in P1, 10 percent in P2 and 4 percent in the legacy portfolio.[1] Allocation is based on WFP's underlying funds and reserves and their expected cash-flow profiles. Asset allocation is reviewed by the Investment Committee before proposals are presented to the Executive Director for decision. In view of the financial crisis and the risk of interest rate increases once the economic outlook improves, most funds are currently maintained in P0 and P1 to limit interest rate and liquidity risks.

15. P0 is invested in money market funds that invest in securities issued or guaranteed as to principal and interest by the United States Government, its agencies or instrumentalities. WFP holds a participation in the funds, which can be accessed on a day-to-day basis, so no investment guidelines are applicable. Trust fund balances are maintained in P0.

16. The investment policy includes a framework for reviewing strategic asset allocations benchmarks and risk-tolerance levels at least once every three to five years. It has been a continuous process since the start of the global financial crisis, in cooperation with the investment adviser.

Actions Taken to Limit the Risk Profile of WFP's Investments

17. This section outlines the amendments to the investment policy and guidelines, recommended by the Investment Committee and the World Bank and approved by the Executive Director, to reduce risk in a response to the global financial crisis.

18. The large increase in volatility and low absolute interest rates have been the main drivers behind the risk reduction process. The risk reduction actions taken in response to the global financial crisis include:

- elimination of what was previously portfolio (P3) which catered for funds and reserves with an investment horizon of three years or longer and had a relatively higher risk profile;
- reduction of eligible securities: mortgage-backed securities are limited to securities issued or guaranteed by government agencies; no longer eligible are housing-related asset-backed securities, commercial mortgage-backed securities and mortgage derivatives;
- new corporate and financial debt securities guaranteed by the Federal Deposit Insurance Corporation are now allowed;
- minimum long-term and counterparty ratings were raised to AA- or AA3; short-term ratings were raised to A1 or P1;
- allocation to credit sectors was reduced considerably;
- revision of benchmarks to reduce the level of credit risk and limit interest-rate risk; and
- inclusion of a stop-loss policy with a view to setting a limit to underperformance among investment managers by forcing them to reduce active risk once a set level is reached.

[1] More information on the legacy portfolio is provided in paragraphs 18 and 19.

19. Securities that no longer comply with the more conservative investment guidelines are maintained in a segregated "legacy" portfolio; the objective is to reduce this portfolio to zero as soon as possible without further cost and taking into account the fundamental value of the underlying securities. These securities are primarily housing-related asset-backed and mortgage-backed securities that were all rated AAA at the time of purchase and were responsible for almost all of the losses incurred in 2008.

20. The legacy portion now accounts for less than 4 percent of the liquidity portfolio, and its potential negative impact on investment performance is very limited. In terms of asset sales, the legacy portion fell from US$152 million at 31 December 2008 to US$55 million at 31 August 2009. During the first of half of 2009, corporate bonds that were no longer in compliance were sold; this includes the three securities that defaulted in 2008. Liquidity in financial markets has improved in recent months: although conditions are far from normal, this has allowed the investment managers to dispose gradually of asset-backed and mortgage-backed securities.

ANNEX

INVESTMENT POLICY: EXECUTIVE DIRECTOR'S CIRCULAR

Purpose

1. The purpose of this Executive Director's Circular is to set out the principles and broad parameters of investment of funds donated and/or entrusted to WFP ('the Programme'), which are not immediately required in Programme implementation (the 'liquidity portfolio'). Investment of funds relating to the Employee Benefits Fund will be made separately, pursuant to the recommendations of an asset/liability management (ALM) study which will be done at least once every three years.

Authority

2. This Investment Policy is developed pursuant to Financial Regulation 11.2 which states, "Monies not required immediately may be invested by the Executive Director, bearing in mind the need for safety, liquidity and profitability". Pursuant to the Decision Memorandum signed by the Executive Director on 28 October 1998, the Programme assumed full responsibility for the management of the cash resources as of 1 January 1999.

Objectives

3. The primary objective of the Investment Policy is the preservation of the value of resources, in US dollar terms. Within this general objective the principal considerations for investment management are: (i) security of principal, (ii) liquidity, and (iii) rate of return. All statements in this Circular are based on mark-to-market accounting principles being used for valuation of investments, in accordance with internationally accepted accounting standards.

Portfolio Tranching

4. In accordance with the investment principles mentioned above, the Programme's cash balances shall be allocated to one of three tranches of the liquidity portfolio, as provided below.

   i) The working-capital portfolio ('P0') shall comprise of working capital funds which may be required on a day-to-day basis by the Programme.

   ii) The short-term portfolio ('P1') shall comprise of other operational funds with a short or uncertain cash-flow profile.

   iii) The medium-term portfolio ('P2') shall comprise of funds that are not expected to be drawn down, on average, over a period of less than one year.

Composition and Rebalancing of Different Tranches

5. The Chief of Treasury is responsible for presenting proposals on the composition and sizes of the portfolio tranches to the Investment Committee. The Executive Director will decide on the composition of the tranches of the liquidity portfolio based on the recommendations of the Investment Committee. The Chief of Treasury will be responsible

for rebalancing the size of the portfolio tranches quarterly based on the cash balances in the different accounts constituting the different tranches at the end of the previous quarter.

Investment Horizon and Risk Tolerance Parameters

6. The investment horizon for any portfolio can be viewed as the minimum length of time or periodicity over which the rate of return on that portfolio, or changes in the market value of that portfolio, have meaningful significance for the Programme and its governing body. The risk tolerance parameters are typically expressed with reference to the specified investment horizon. Accordingly:

i) P0 shall be invested with an investment horizon of one day, in a manner that there is no probability of negative total return on the portfolio over this investment horizon.

ii) P1 shall be invested with an investment horizon of three months, in a manner that there is no probability of negative total return on the portfolio over this investment horizon.

iii) P2 shall be invested with an investment horizon of one year, in a manner such that there is negligible probability of a limited negative total return on the portfolio over this investment horizon.

Benchmarks

7. The different tranches of the liquidity portfolio will be managed by internal or external managers against the following benchmarks:

i) P0: US T-Bill, 0–3 months index

ii) P1: US T-Bill, 3 months index

iii) P2: US Treasuries, 0–3 year index

Investment Guidelines

8. The main elements of the investment guidelines for management of the P0, P1 and P2 portfolios against the benchmarks specified in the previous paragraph are attached.

Responsibilities of External Investment Managers

9. Subject to the contract between the Programme and the external investment manager, the external investment manager shall be responsible for making all investment decisions regarding the assets under its management, including the decisions to buy, sell and hold securities, and will be held accountable for following the investment guidelines and achieving the investment objectives as stated in the contract.

Performance Evaluation of External Investment Managers

10. The performance of external investment managers shall be measured relative to the benchmark, ex-ante annualized tracking error target (risk budget), and excess return objective, as specified in the contract. In particular, the main criteria for evaluation will be:

i) Excess Returns (defined as the total return on the portfolio less benchmark return; with total return calculated on a time-weighted basis combining capital gains and losses and interest income, adjusting for cash inflows and outflows, and compounding monthly) for rolling 12- and 36-month periods;

ii) Ability to manage risk by staying within the ex-ante tracking error target (risk budget) and other investment guidelines specified in the contract; and

iii) Information Ratio for rolling 12- and 36-month periods, determined by dividing the annualized Excess Return by the ex-post tracking error (defined as the annualized standard deviation of the monthly Excess Returns).

Termination of External Investment Managers

11. The contract of any external investment manager may be terminated for the following reasons:

i) failure to take any actions specified in the contract;

ii) failure to meet the performance objectives specified in the contract;

iii) a significant change in investment style and/or investment process at any time subsequent to their selection as an investment manager by the Programme;

iv) a significant change in the composition of their investment team at any time subsequent to their selection as an investment manager by the Programme;

v) any change in the Programme's investment policy which renders an external investment manager, in Programme's judgment, unsuitable to manage the funds entrusted to them; and

vi) any other developments which, in the Programme's judgment, render a manager unsuitable for continuing with their contract.

Responsibilities of the Global Custodian

12. Subject to the contract between the Programme and the Global Custodian, the Global Custodian is responsible for core custody products such as safekeeping of assets, settlement of transactions, collection of income, tax reclamation, valuations and portfolio accounting. The Global Custodian may provide other ancillary services such as risk analysis, performance measurement, and compliance reporting, in accordance with needs determined by the Programme.

Periodic Review of Strategic Asset Allocation and Benchmarks

13. The strategic asset allocation of the different tranches and their benchmarks shall be reviewed periodically to ensure that they are consistent with the risk tolerance parameters specified in paragraph 6, particularly in the event of significant changes in the market environment, such as the level of interest rates.

Periodic Review of Investment Policy and Risk Tolerance

14. The overall tranching structure of the liquidity portfolio specified and the risk tolerance parameters specified in paragraph 6 shall be reviewed at least once every 3–5 years to ensure that the investment policy framework adequately reflects the evolving nature of the Programme's mission and operations.

Implementation

15. The Investment Committee is instructed to ensure that the appropriate operational procedures and guidelines are prepared and approved in line with this policy.

Investment Policy Annex I: Main Elements of Investment Guidelines for P0, P1 and P2 Portfolios

1. **Risk Budget for Active Management** (specified as ex-ante annualized tracking error target)

   P0: none

   P1: 40 basis points

   P2: 50 basis points

2. **Benchmarks**

   P0: US T-Bill Index, 0–3 months index

   P1: US T-Bill Index, 3 months index

   P2: US Treasuries, 0–3 year Index

3. **Excess Return Objectives**

   P0: none

   P1: 50 basis points

   P2: 25 basis points

4. **Eligible Instruments**

   P1 and P2

   a) Government Securities (Govt. Bonds). Any ‘marketable’ bond, note or other obligation issued or unconditionally guaranteed by a sovereign government from the following list, and denominated in the currency of the countries specified below:
   Australia, Canada, Denmark, Euro Area (comprising Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain), Japan, Norway, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States of America.

   b) Government Agency, Other Official Entity and Multilateral Organization Securities (Agencies). Any marketable bond, note or other obligation issued or unconditionally guaranteed by the agency or instrumentality of a sovereign government, or any other official entity (such as regional authorities, municipalities and other entities established to serve a governmental purpose) in countries listed at a) above, or a multilateral organization, and denominated in US dollars. This section includes corporate and financial debt securities, explicitly guaranteed by the Federal Deposit Insurance Corp (FDIC).

   c) Bank and Other Financial Institution Obligations (Bank Obligations). Obligations of commercial banks and bank holding companies, including commercial paper, bankers’ acceptances, certificates of deposit, time deposits, notes and bonds; denominated in US dollars, provided that these obligations will mature in less than one (1) year.

   d) Corporate Securities (Corporates). Obligations of corporations, including commercial paper, notes, bonds and medium-term notes, including those issued under a 144A or Reg S exemption, denominated in US dollars, provided that the obligation is rated equal to or better than AA- by Standard & Poor’s (S&P) or Aa3 by Moody’s and that the obligation has a maximum remaining maturity of 5 years at the time of purchase. Floating Rate Notes (FRNs) issued by bank and other financial institutions are allowed as long as the rate refix period is less than one (1) year.

e) Asset-backed securities (ABS). ABS issued or unconditionally guaranteed by a corporate entity or trust, denominated in US Dollars, provided that the obligation is rated AAA by S&P or Aaa by Moody's. ABS Home Equity Loans, ABS HELOC, CDOs and CLOs are not allowed.

f) Agency Mortgage-backed Securities (MBS). Agency MBS issued or unconditionally guaranteed by agencies of a sovereign government in countries listed at paragraph a) above, provided that the obligation is rated AAA by S&P or Aaa by Moody's, including mortgage pass-through securities, to be announced forward settling mortgage pass-through securities (TBAs), collateralized mortgage obligations (CMOs), and traditional and hybrid adjustable rate mortgages (ARMs). Non-Agency MBS, Commercial MBS and mortgage derivatives (e.g. IOs, POs, inverse floaters, CMO residuals) are not allowed.

g) Repurchase Agreements ('Repos'). Repos and reverse repurchase agreements with major commercial banks and primary dealers rated AA- by S&P or equivalent by another rating agency, against securities eligible under a) and b) above, to be held by the Custodian. The securities should have a market value, including accrued interest, equal to or greater than the amount invested in the repurchase agreements or reverse repurchase agreements. Such transactions should be marked to market daily. Repurchase agreements and reverse repurchase agreements shall be subject to a maturity limit of ninety (90) days.

h) Fixed-income Derivatives. Financial futures, forwards, options contracts, and swaps, on fixed income securities otherwise eligible for investment or for the purpose of currency management. These instruments may be either traded on an exchange or actively traded in the over-the-counter market.

SECTOR LIMITS, AS PERCENTAGE OF INVESTMENT ACCOUNT ASSETS (%)		
Sector	**P1**	**P2**
Government agencies	40	50
Agency MBS	25	30
Corporates	10	10
ABS	10	10
Bank obligations	25	35

5. **Credit Risk** (subject to credit rating limitations already specified at Section 3 above)

a) Short-term rated investments (one year or less of remaining maturity at the time of purchase): each investment shall carry a rating equal to or better than A1 by Standard & Poor's (S&P) or P1 by Moody's at the time of purchase.

b) Long-term rated investments: each investment shall carry a rating equal to or better than AA- by S&P or Aa3 by Moody's at the time of purchase; in the event of a split rating, a rating of A+ by S&P or A1 by Moody's is permitted.

c) No more than five percent (5%) of the market value of the IAA shall be invested, at the time of purchase, in long-term rated investments with a rating equal to A+ by S&P*, or its equivalent by another rating agency.

d) At the time of purchase, with the exception of issuers under 4 a) and b) above and any issuers for whom the Benchmark holdings exceed these limits, no more than five percent (5%) of the market value of the IAA shall be invested in the obligations of any one issuer or issuing trust of structured securities, including obligations of any affiliates or subsidiaries of such issuer. This limit shall be two percent (2%) in the case of any issuer with a credit rating equal to A+ by S&P,[1] or its equivalent by another rating agency.

e) For all forward settlements, including mortgage-backed securities, foreign exchange, futures and options contracts, swaps and all over-the-counter derivatives, the counter-parties will be rated at least AA- by S&P or its equivalent by another rating agency.

6. Duration Risk

DURATION RISK (RELATIVE TO WEIGHTED AVERAGE DURATION OF THE BENCHMARK)		
Duration	**P1**	**P2**
	Zero months to benchmark plus four (4) months	Benchmark plus or minus six (6) months

7. Currency Risk

The base currency for the P1 and P2 portfolios is the US dollar. Any non-US dollar securities must be fully hedged back to the US Dollar.

8. Stop loss Policy

The overall market risk of the portfolios relative to the applicable benchmarks will be controlled by a stop loss limit on potential drawdown versus the benchmarks. The stop loss limits are set at 80 basis points for P1 and 100 basis points for P2 versus the applicable benchmarks. If at any time during the calendar year, the return of the portfolio reaches the stop loss limit, below the return of the applicable benchmark, the Programme will be consulted on whether or not to revert to a benchmark replication strategy for an agreed period.

[1] Applicable in the event of split rating