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BOARD  
MEETING**

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**CONFIDENTIAL**

December 10, 2021

To: Members of the Executive Board  
From: The Secretary  
Subject: **Review of the Investment Account and Trust Assets Investment Strategy**

Board Action:	Executive Directors' <b>consideration</b> (Formal)
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Questions:	Mr. Brennan, FIN (ext. 34653) Ms. Rustaman, FIN (ext. 35481) Mr. Racic, LEG (ext. 34115)





## REVIEW OF THE INVESTMENT ACCOUNT AND TRUST ASSETS INVESTMENT STRATEGY

### EXECUTIVE SUMMARY

**This paper provides analysis to support the Board's first concurrent review of the investment strategies for the Investment Account (IA) and Trust Assets (TA).** It covers both the IA subaccounts—the Endowment Subaccount (EA) and the Fixed-Income Subaccount (FI)—as well as the TA, which is comprised mainly of Poverty Reduction and Growth Trust (PRGT) investment assets. Building on an informal discussion with Executive Directors last June, the paper advances earlier proposals for refining the EA and FI investment strategies to maintain an appropriate balance of risk and income generating potential. New proposals are presented for the PRGT, building on the outcome of the recent Review of Concessional Finance and Policies.

**A further evolution of the EA investment strategy is proposed to improve prospective returns.** While the outlook for future market returns has deteriorated, staff sees a case for maintaining the EA's long-term return target for the time being, in line with the Board's guidance in June. Refinements to the EA strategy are proposed to bring projected returns closer to the target while maintaining a balanced portfolio which is resilient in different economic and inflation regimes. In addition, a simplified structure is proposed for the EA which would enable more targeted use of active management, replacing the current 'core-satellite' model.

**The refinements proposed for the FI investment strategy are more incremental and aimed at sustaining the subaccount's recent performance without materially changing its risk profile.** The incremental refinements build on experience with the recently expanded strategy. The strategy has performed well, benefitting from diversification across a broadened set of high grade fixed-income assets and effective implementation. It is also recommended that a numerical return target be established for the FI to specify more clearly the preferred risk versus return profile consistent with the FI's dual objectives.

**Limited refinements are proposed to the PRGT investment strategy and no changes are recommended for the other TA.** Following the recent Review of Concessional Financing and Policies, the changes proposed to the PRGT investment strategy are aimed at augmenting its reserve-like qualities. Specifically, the proposal calls for increasing the allocation to PRGT's short duration fixed-income (SDFI) assets

and enhancing this portfolio component through a similar investment approach to the FI. The enhanced SDFI could also offer an attractive standalone investment alternative for contributors to the PRGT. Overall, the PRGT's refined strategy would remain well positioned to meet the Trust's investment objectives without increasing portfolio risk.

**Based on Directors' earlier guidance, this paper also proposes that the Board formalizes a commitment to responsible investing for the IA and TA.** This commitment would be established in the Rules and Regulations for the IA ("IA Rules") and the Guidelines for Investing PRG, PRG-HIPC and CCR Trust Assets ("TA Guidelines") with a requirement for the Managing Director to maintain a principles-based policy for responsible investing.

**A review of the Fund's framework for managing investment-related conflicts of interest was conducted.** As described more fully in the supplemental paper, the review identifies potential refinements to the Fund's framework based on an assessment of current practices of the Fund and select peers. The consultation with the Board on the findings of this review will inform any refinements to the Fund's conflicts framework by Management and the Investment Oversight Committee (IOC).

**Relevant changes are reflected in proposed revisions to the IA Rules and TA Guidelines** (Annex I through IV). These changes are subject to approval of the Executive Board by a 70 percent majority of total voting power.

Approved By  
**Bernard Lauwers and  
 Rhoda Weeks-Brown**

Prepared jointly by a staff team from the Finance and Legal Departments, led by Mr. Brennan (FIN) and Mr. Patterson (LEG) and consisting of Mses. Benhaddou, Nachnani, and Rustaman and Messrs. Attié, Farahmand, Hasnain, Kumtakar, Xie, and Zhu, with contributions from Ms. Rutkowska and Messrs. Gumbanjera, Nana, and Ndiaye (all FIN); and Ms. Carreathers and Messrs. Joseney, Pham, and Racic (all LEG). Administrative assistance was provided by Jennifer Chidiac (FIN). The IOC reviewed this report.

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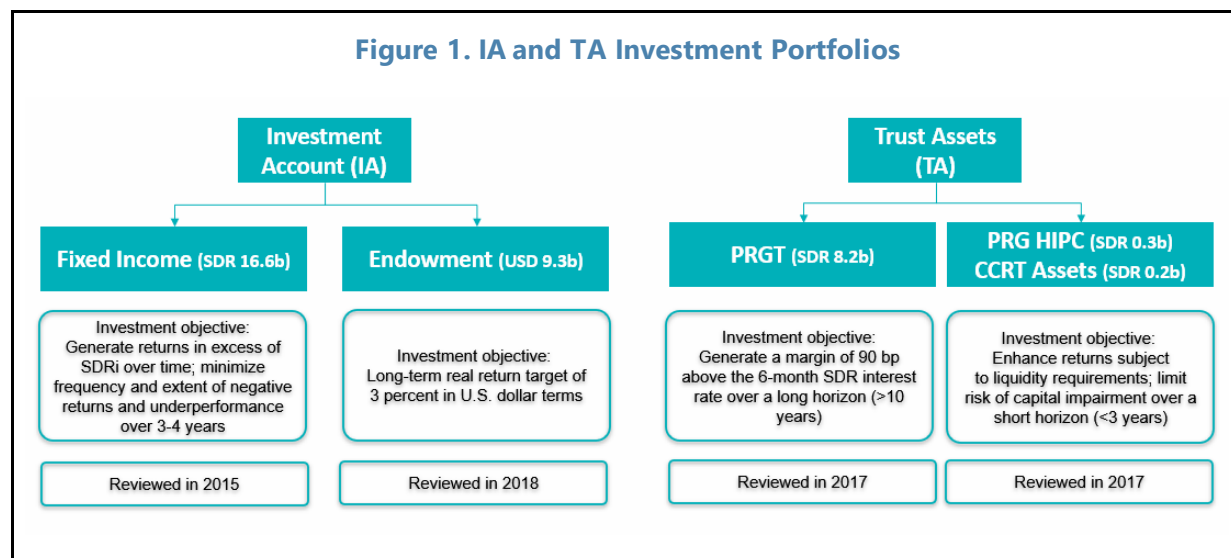
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## Glossary

bp	Basis points
CCRT	Catastrophe Containment and Relief Trust
CPI	Consumer Price Index
CVaR	Conditional Value-at-Risk
DIA	Deposit and Investment Account
DM	Developed Markets
EA	Investment Account Endowment Subaccount
EM	Emerging Markets
ESG	Environmental, Social, and Governance
FI	Investment Account Fixed-Income Subaccount
GED	Global External Deflator
GRA	General Resources Account
IA	Investment Account
IA Rules	Rules and Regulations for the Investment Account
IOC	Investment Oversight Committee
NIM	New Income Model
PRG-HIPC	Poverty Reduction and Growth Operations for the Heavily Indebted Poor Countries Trust
PRGT	Poverty Reduction and Growth Trust
REITs	Real Estate Investment Trusts
RST	Resilience and Sustainability Trust
SAA	Strategic Asset Allocation
SDFI	Short duration fixed-income
SDR	Special Drawing Rights
SDRi	3-month SDR interest rate
SRA	Subsidy and Reserve Account
TA	Trust Assets
TA Guidelines	Guidelines for Investing PRG, PRG-HIPC and CCR Trust Assets
TIPS	Treasury Inflation-Protected Securities
VaR	Value-at-Risk

## INTRODUCTION

1. **This paper examines the IA and the investment strategies for the TA.** It provides analysis to support the Board’s first concurrent and comprehensive review of the investment objectives and strategies of the two IA subaccounts—the EA and the FI—and the TA (Figure 1). The paper builds on the Board’s initial discussion last June which focused on each portfolios’ past performance, return outlook, and possible approaches to ensure that the respective investment strategies maintain an appropriate balance of risk and income generating potential going forward.



2. **Directors were broadly supportive of the approaches presented in the initial considerations paper last June and provided helpful guidance for further work.** Based on their guidance, this paper advances the earlier proposals to refine the investment strategies for the EA and FI to improve portfolio return prospects and resilience in the challenging market environment. Reflecting Directors’ feedback, revised proposals are presented for the EA’s and FI’s return objectives. New proposals are also presented for PRGT’s investments to reflect the outcome of the recent Review of Concessional Financing and Policies.<sup>1</sup> This paper also advances staff’s earlier recommendation that the Board formalizes a responsible investing commitment for the IA and TA.

3. **This paper is presented together with a supplement on the Review of Conflict of Interest Framework for the Investment Account and Trust Assets.** In line with the IA Rules and the TA Guidelines, a review of the Fund’s framework for managing investment-related conflicts of interest was conducted. The supplemental paper provides background on the Fund’s framework, discusses key observations from a peer benchmarking exercise, and describes potential refinements to the Fund’s framework based on an assessment of current practices. The consultation with the

<sup>1</sup> *Fund Concessional Financial Support for Low-Income Countries—Responding to the Pandemic* (SM/21/120, 06/30/2021).

Board on the findings of this review will inform any refinements to the Fund’s conflicts framework by Management and the IOC.

#### **4. Relevant changes are reflected in proposed revisions to the IA Rules and the TA**

**Guidelines.** The proposed strategy refinements require an amendment to the IA Rules and the TA Guidelines. These changes are subject to approval of the Executive Board by a 70 percent majority of total voting power. In line with the current governance structure, the refinements would be implemented by the IOC subject to the Managing Director’s delegation of authority.

## **ENDOWMENT SUBACCOUNT**

### **A. Background, Performance, and Recent Developments**

**5. The Board’s last review of the EA in 2018 initiated a gradual evolution of its investment strategy and established a framework for guiding future payouts of investment income.** Although the EA had met the 3 percent long-term real return target, Directors recognized the challenges in achieving the return objective in the future. A number of gradual refinements to the EA’s investment strategy were adopted with the aim of improving the portfolio’s potential return (Figure 2). One notable refinement was a proposal to introduce private infrastructure debt in the EA, which was subsequently approved in 2019.<sup>2</sup> During the 2018 review, the Board also agreed on a framework for guiding future payouts of investment income from the EA.<sup>3</sup> Under this framework, payouts would follow a constant real payout rule supplemented by certain safeguards to help protect the real value of the portfolio. These safeguards included delaying the initial payout to build up a cushion of retained investment income in the EA and aligning the value of the payout with the prevailing outlook for returns on the investment strategy.

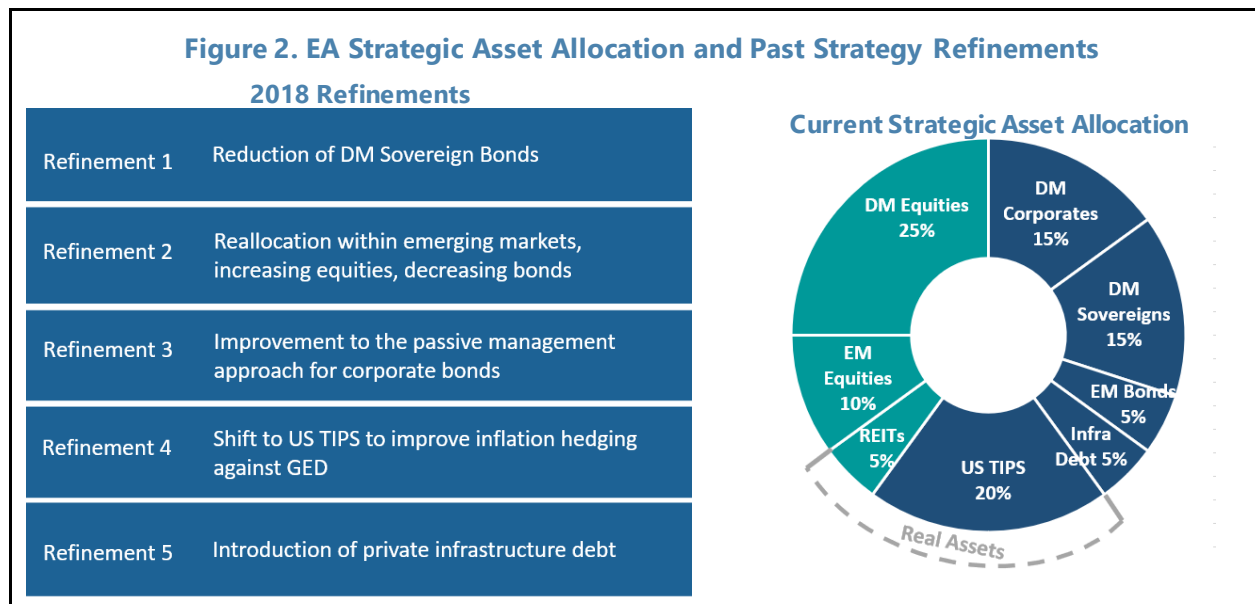
**6. The EA’s investment strategy has continued to perform better than expected and returns have exceeded the long-term target.** Since its inception in 2014, the EA has returned 5.89 percent on an annualized basis, which is 37 bp above its return target of 3 percent over the Fund’s Global External Deflator (GED) (Annex V). Overall, the EA has benefitted from the strong market performance during the period since the last review.<sup>4</sup> Fixed-income investments have been supported by the decline in developed market bond yields to historic lows, while accommodative monetary and fiscal policies implemented following the COVID-19 market crash in March 2020 triggered an exceptionally strong recovery in equity markets. Although the equity allocation comprises only 40 percent of the EA strategy, its returns have contributed over 60 percent to the total return since inception. The realized volatility of the EA’s return has increased to around

<sup>2</sup> *The Investment Account—Introducing Private Fixed Income in the Endowment Subaccount* (SM/19/80, 04/12/2019).

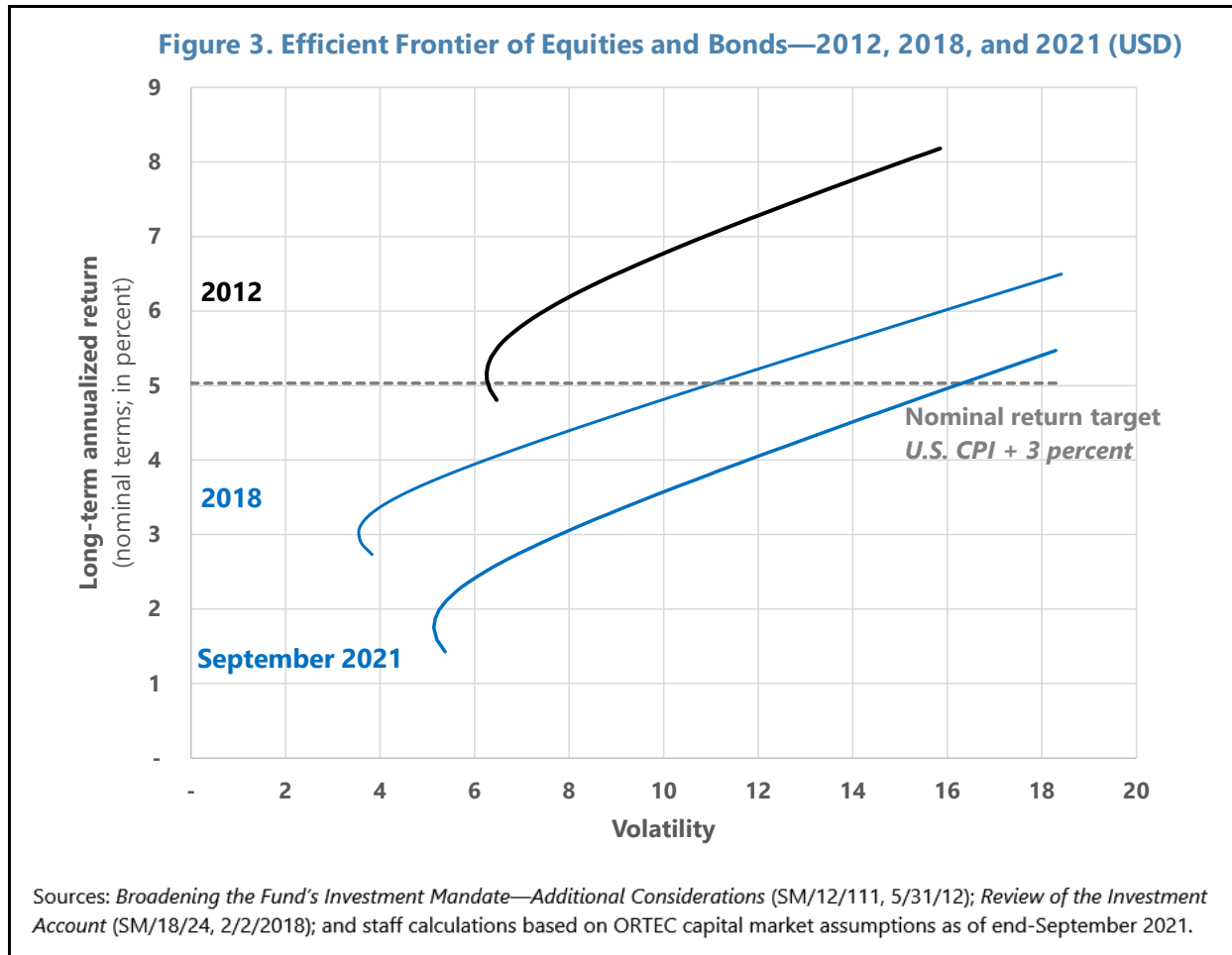
<sup>3</sup> *Review of the Investment Account* (SM18/24, 02/02/2018) and *The Acting Chair’s Summing Up* (SU/18/31, 3/09/2018).

<sup>4</sup> The strategy refinements implemented in 2018 also contributed a performance improvement of approximately 7 bp per annum in aggregate.

6 percent from 4.6 percent at the time of the last review but is still well below the original long-term expectation of 8-9 percent. The increase was largely a result of the COVID-19 market crash.



**7. Since the last review, the decline in risk free interest rates has lowered expected investment returns across all asset classes even further and the outlook for inflation has become more uncertain.** Lower bond yields will inevitably result in diminished returns for fixed income, and elevated valuations are a headwind for some equity markets. The projected risk-to-return frontier for portfolios of equities and bonds has moved markedly lower over the ten years since the EA's original strategy was established. This implies that larger allocations to equities and increasingly higher return volatility would need to be tolerated to reach the EA's 3 percent real return target (Figure 3). However, the risk-to-return frontier has also steepened, indicating that the reward for incremental risk has increased. The highly accommodative fiscal and monetary policies introduced to address the economic impact of the COVID-19 pandemic, and the U.S. Federal Reserve's new average inflation targeting framework have pushed short- and long-term inflation expectations higher and increased uncertainty around the inflation outlook.

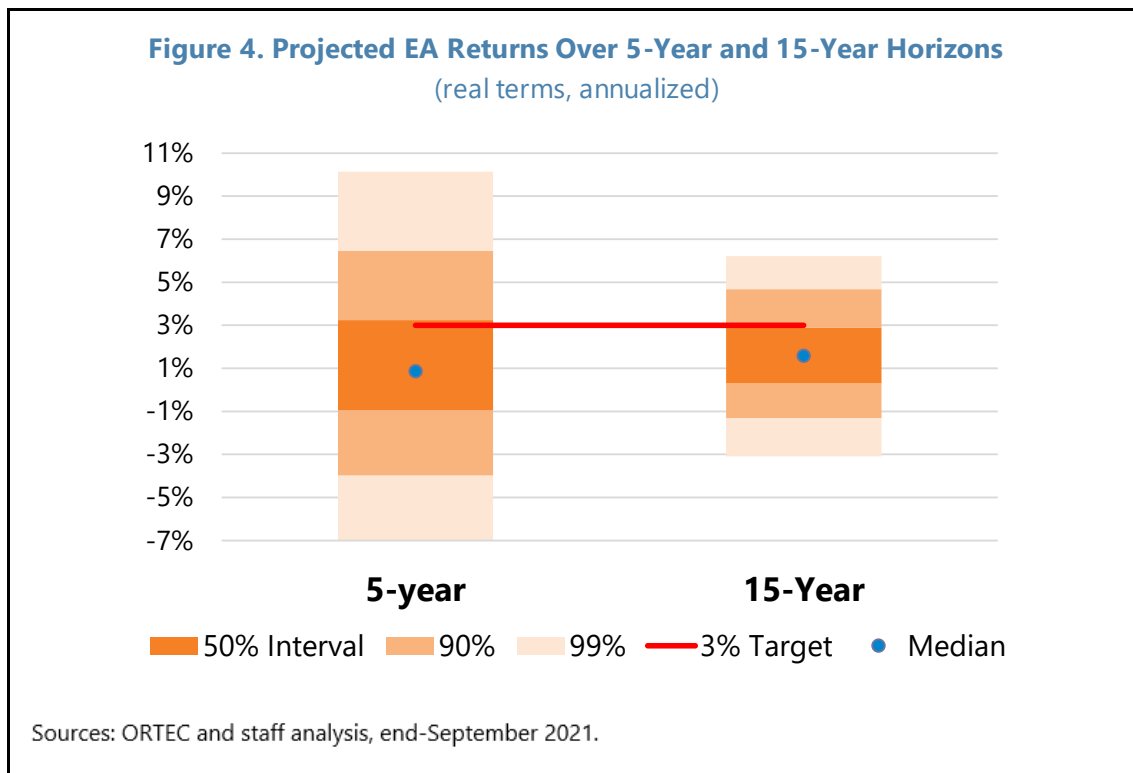


## B. Investment Objectives and Strategy

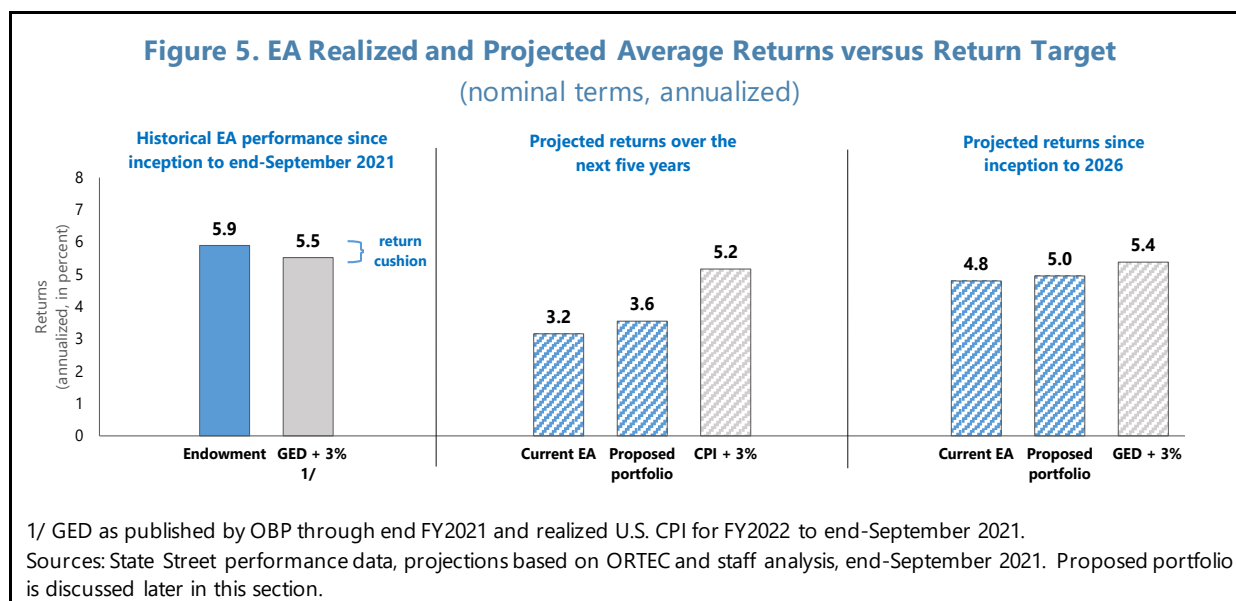
**8. While the EA has achieved its 3 percent real return target since inception, it is unlikely that the current strategy will meet the target over the next 15 years.** Under current baseline projections, the existing strategy is expected to return around 1.6 percent in real terms with around a 23 percent probability of achieving the 3 percent target over the next 15 years. In other words, there is a roughly a three-in-four chance that the return target will not be achieved over the long-term (Figure 4). Given that the strategy maintains a majority allocation to fixed income and the near certainty lower bond yields will ultimately result in lower long-term returns, achieving the return target would require an unrealistically strong performance from equities or a significantly greater portfolio allocation to equities.<sup>5</sup> While an allocation to risk assets of 60 to 80 percent may not be unusual for many long-term investment portfolios, it would represent a deviation from a balanced strategy and go beyond the otherwise gradual evolution of the EA portfolio envisaged when it was created. For these reasons, staff had suggested in their earlier paper that consideration be given to

<sup>5</sup> For example, a portfolio with 60 percent DM equities, 20 percent EM equities, and 20 percent global government and corporate bonds has a long-term projected real return of around 2.9 percent based on market conditions as of September 2021 (reflecting lower asset returns projections and higher inflation since the initial paper).

both lowering the EA’s return target and making more moderate refinements to the investment strategy to improve potential performance.



**9. Based on Directors’ guidance, staff proposes maintaining the 3 percent real return target for the time being.** At the June discussion, Directors considered staff’s initial suggestion to lower the return target in light of the material deterioration in the outlook for future market returns. A number of Directors expressed a preference for retaining the target for the time-being. They viewed the target as a long-term goal and noted that it was too soon to reduce the target given that realized performance continues to exceed it. Most Directors preferred to consider further enhancements to the investment strategy at this time. Some also observed that leaving the target unchanged would have no direct impact on the disposition of investment income since payouts are based on projected returns on the EA strategy. Viewing the 3 percent real return target as a long-term goal, it is reasonable to consider realized performance to date in addition to future return projections. On this basis, even if the lower projected returns are realized over the next five years, the EA’s return since inception could still be close to the target (Figure 5). For this reason, staff proposes retaining the target for the time being and reassessing it again at the next 5-yearly review.



**10. There is considerable scope to increase the EA’s allocation to riskier assets to improve potential investment returns.** Given the EA’s long-term investment horizon, there is capacity to increase its allocation to riskier assets. Also, the EA has a more conservative strategy and risk profile than typical long-term endowment portfolios. As discussed in staff’s earlier paper, most endowments hold a much larger allocation of equities and many also hold sizeable allocations to illiquid or alternative assets (such as private equities and hedge funds) depending on their return or payout targets. The higher short-term volatility of these assets can be tolerated since the key risk for these portfolios, like for the EA, is erosion of the real value of capital and reduction in the real value of payouts over the long-term. Given the room to expand the risk profile, and the relatively attractive compensation for accepting additional risk at this time, there is a good case for refining the EA’s asset allocation and asset class diversification to seek higher potential returns. While Director’s views on the EA’s risk tolerance varied, most expressed preliminary support for the measured refinements to the EA’s investment strategy recommended by staff.

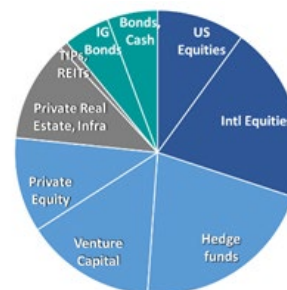
**11. Maintaining a relatively balanced distribution across fixed income, equities, and real assets continues to be important for the long-term resilience of the EA.** An asset allocation with a good balance across assets geared to income generation, growth, and inflation protection will be resilient through different economic regimes over time. In addition, the EA’s strategy should achieve suitable diversification across asset classes within each of these three broad categories. Staff reviewed the suitability of different asset classes for possible inclusion in the EA (Box 1). Based on their analysis of alternative assets and investment arrangements, they concluded that the EA’s existing asset classes, with some expansion within the real assets category, provide sufficient room for gradual strategy refinements to improve the portfolio’s long-term return potential and resilience. Broadly, the proposed refinements would adjust the EA’s asset allocation along the following lines: (i) reducing the allocation to low yielding fixed-income assets and improving diversification within the fixed-income allocation; and (ii) expanding and diversifying the allocation to real assets. These refinements, which were discussed in staff’s initial paper, are described further below and summarized in Figure 6.

### Box 1. Selected Considerations for the EA Asset Class Inclusion

**Staff continues to review a broad range of assets which have the potential to support the EA's investment objectives.** The following summarizes their current assessment of the suitability of several asset types included in many peer portfolios:

**Alternative investments** such as private equity and hedge funds were considered at the EA's inception. While these investments are commonly included in endowment portfolios for their return generating potential and low correlation with traditional investments (Figure 1), they were not selected for the EA at the time. They were not considered suitable given the EA's preferred implementation arrangements (e.g., passive management and low fees) and because they could introduce significant reputational risk to the Fund.<sup>1/</sup> For example, most hedge funds have active strategies based on high leverage and short selling, both of which are not permitted for the EA. In addition, they are subject to less regulation and are much less transparent than traditional investments. The performance of investments in hedge funds and private equity is also highly dependent on manager selection, which introduces significant implementation risk. For these reasons, staff continues to consider these alternative investments as unsuitable in general for the EA.

**Figure 1. Asset Allocation of US College Endowments**



Source: 2020 NACUBO-TIAA Study of Endowments.  
Note: IG bonds-investment grade.

**Fixed-income investments in sub-investment grade sectors** such as high yield bonds were also considered at the EA's inception but not included due to credit risk considerations.<sup>2/</sup> High yield bonds and other non-traditional fixed-income sectors were explored again by staff for this review, due to their potential to provide return enhancement and diversification - the historical performance of high yield bonds is more highly correlated with equities than the performance of investment grade fixed income is.<sup>3/</sup> Staff's research indicated though that these assets are not well suited for a long-term strategic asset allocation as the broad characteristics of the high yield sector can evolve significantly over time. For this reason, high yield bonds are normally included as a more tactical option by other investors in an actively managed multi-sector fixed-income allocation, however, this approach would be very challenging to implement under the EA's current structure and governance arrangements.

**Real assets** are particularly attractive for the EA given their inflation protection and income-generating potential. However, characteristics of real assets can vary widely and they are not always grouped together as a single asset class. For example, TIPS are considered fixed income while real estate investment trusts (REITs) are considered equities. Some equity investments in utilities, transport, and other infrastructure sectors are also considered to be real assets. Staff highlighted the specific benefits of real estate and infrastructure investments in the initial paper in June.<sup>4/</sup> There are strong similarities between the real estate and infrastructure sectors and some overlap between the two (e.g., data centers). These investments provide long-term exposure to high-quality asset-backed cash flows that have the potential to reset higher as prices and inflation rise. In addition, their range of low correlations to a wide variety of assets further adds to their potential diversification benefit. Publicly listed real estate and infrastructure equities have a higher yield than overall equities and bonds, making them particularly attractive in the current low yield environment. While these investments will exhibit high short-term volatility similar to or possibly higher than other equities, their returns have potential for more rapid mean reversion over long-horizons (as demonstrated by historical REITs returns). Public market securities such as listed real estate and infrastructure equities have kept pace with

### Box 1. Selected Considerations for the EA Asset Class Inclusion (Concluded)

private investments over time despite short-term deviations in performance. However, targeted private investments may present good opportunities for diversification and will be considered in the future.

1/ *Asset Allocation Under a Broadened Investment Mandate—Preliminary Considerations* (SM/10/306, 12/1/2010).

2/ *Broadening the Fund's Investment Mandate—Further Considerations* (SM/11/205, 8/5/2011).

3/ Other fixed-income sectors included preferred securities, bank loans, collateralized loan obligations, commercial mortgage-backed securities and convertible bonds.

4/ Box 1, *Review of the Investment Account and Trust Assets Investment Strategy—Initial Considerations* (FO/DIS/21/75, 5/19/2021).

### Refinements to Fixed-Income Assets

**12. A further reduction in the EA's allocation to government bonds by 5 percent will limit the potential drag on portfolio return from this asset class.** The Board approved a small reduction in the allocation to DM government bonds in the 2018 review, given the low return prospects and relatively large allocation. Since then, government bond yields in developed markets have declined further in response to central banks' monetary support following the COVID-19 outbreak. Yields are now at levels that offer little income and limit the ability of DM government bonds to protect the value of the EA during market shocks. The large allocation to fixed income also increases the risk of the EA losing purchasing power if emergent inflationary pressures are sustained.

**13. In addition, combining the developed and emerging market bond allocations into global allocations for government and corporate bonds respectively would improve the diversification of the EA's fixed-income holdings.** Staff envisages that the proposed global government allocation would be managed against a GDP-weighted index in line with the current implementation arrangements for the DM government bond allocation. Under this weighting, the proposed 5 percent reduction in the overall global government allocation will fall largely on the DM component, as intended, and the allocation to EM government bonds would be almost unchanged.<sup>6</sup> This will improve the overall country diversification across all the eligible, BBB+ and higher-rated government bond issuers. In implementing the global government mandate, staff also envisages that currency risks for bonds denominated in EM currencies would be hedged, as is currently the case for bonds denominated in DM currencies. To enable this, the Board would need to amend the IA Rules to permit hedging of currency risks for fixed-income securities denominated in EM currencies.<sup>7</sup> For the global corporate bond allocation, adding hard currency EM corporate bonds,

<sup>6</sup> The EA's current strategy includes a 15 percent allocation to DM government bonds and a 5 percent allocation to EM. Under the proposed 15 percent allocation to global government bonds and the GDP-weighted index, the allocations to DM and EM government bonds would be 10.5 percent and 4.5 percent respectively.

<sup>7</sup> In the past, currency hedging of EM bonds denominated in local currencies was not recommended for the EA due to concerns of potentially high costs and limited hedging instruments in some markets. However, given the high minimum credit rating requirement for the EA's government bond allocation, hedging instruments are available for eligible EM countries and hedging costs are considered effective, as confirmed by external managers.

which were already eligible for the EM bond allocation, would expand the opportunity set to improve portfolio diversification and enhance yield.<sup>8</sup>

### ***Refinements to Real Assets***

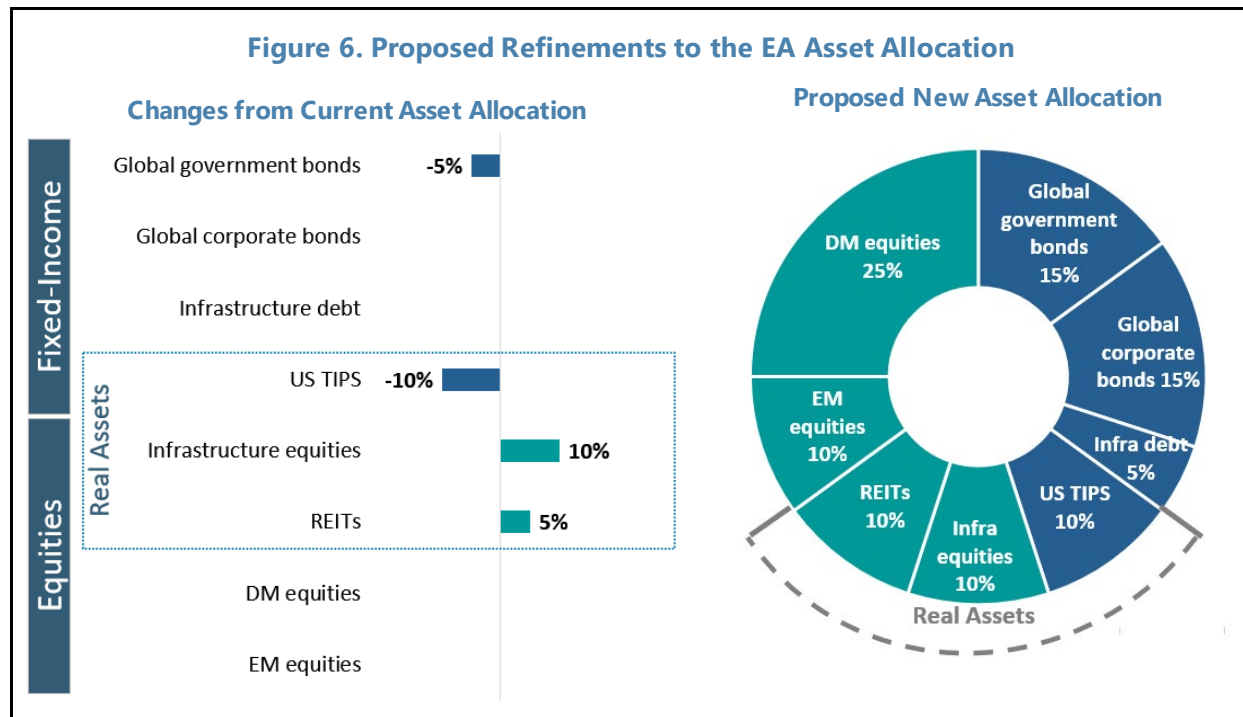
**14. Staff proposes diversifying and moderately increasing the EA's allocation to real assets to target equal 10 percent allocations to US TIPS, real estate investment trusts (REITs), and infrastructure equities.** The EA's current allocation to real assets is heavily concentrated in US TIPS (20 percent) with the remainder (5 percent) in REITs. The allocation to real assets is intended to provide inflation protection to the EA and enhance income generation. However, the large allocation to US TIPS will likely become a significant drag on the portfolio's performance going forward. US TIPS now trade at deeply negative real yield levels, which are well below the EA's real return target. The proposed reallocation from US TIPS to other real assets would improve the EA's return generating potential while maintaining long-term resilience against inflation. As discussed in detail in the initial paper, real estate and infrastructure are particularly well suited for the EA.<sup>9</sup> They offer genuine portfolio diversification over time, stable real income streams, and relatively high yields compared to other assets. In addition, while REITs and infrastructure equities will have similar return volatility to other equities over the short-term, they exhibit lower volatility over longer periods which makes them particularly suitable for long-term portfolios. A moderate increase in the REITs allocation and a new dedicated allocation to publicly listed infrastructure equities would improve the EA's overall expected return while maintaining long-term resilience against inflation.<sup>10</sup> Further details on the implementation of the proposed REITs and infrastructure equities allocations are provided in Section C.

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<sup>8</sup> The EA's corporate bond managers estimate to include around 5 to 10 percent to EM issuers in a global corporate bond mandate which could enhance overall yield by up to 10 bp.

<sup>9</sup> Box 1, *Review of the Investment Account and Trust Assets Investment Strategy—Initial Considerations* (FO/DIS/21/75, 5/19/2021).

<sup>10</sup> The EA's existing DM and EM equity benchmarks already include listed infrastructure equities. The EA has also recently implemented a limited allocation to private infrastructure debt as part of its fixed-income assets.

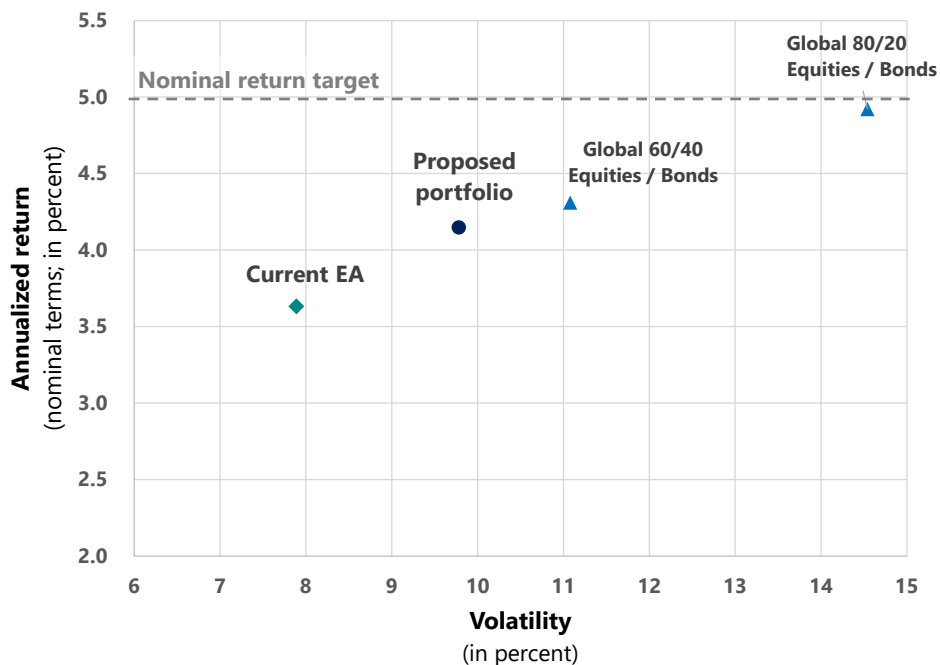


### Overall Strategic Asset Allocation

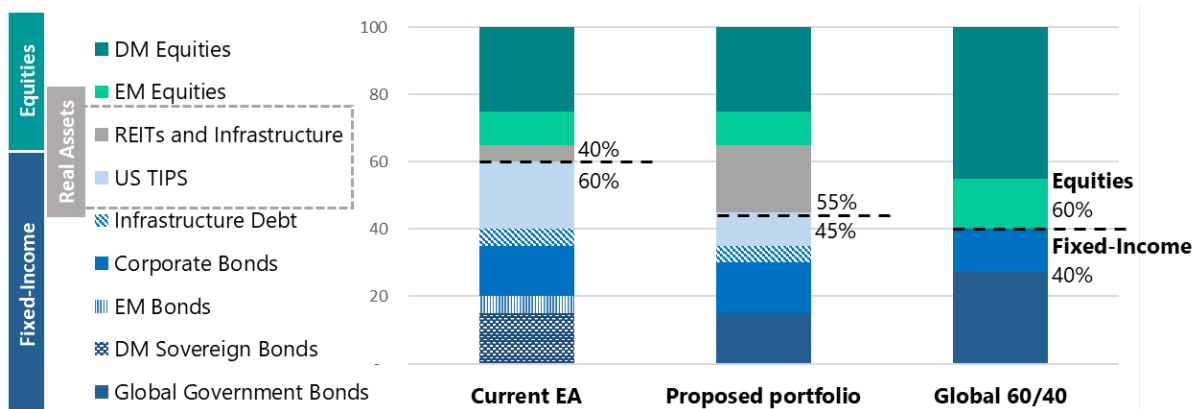
**15. The proposed strategic asset allocation has the potential to generate higher returns compared to the current asset allocation albeit with somewhat higher return volatility and downside risk.** As shown in Figure 7, the proposed asset allocation is expected to return around 2.1 percent in real terms with a higher likelihood than the current asset allocation of achieving the EA's 3 percent real return target over the next 15 years. With an allocation to the different equity sectors totaling 55 percent, the return volatility of the proposed portfolio moves closer to that of a global 60/40 equity/bond strategy, which is a well-accepted reference benchmark for a balanced equity/bond portfolio. However, the proposed portfolio, which has a better balance to fixed income, equities, and real assets (including real estate and infrastructure equities), is expected to have meaningfully lower downside risk and superior long-term resilience against worst-case scenarios, as shown in Annex VI. Staff's estimate of the EA payout would also be higher under the proposed strategy due to its better projected return and downside risk characteristics relative to the current strategy as well as the 60/40 reference benchmark.<sup>11</sup>

<sup>11</sup> The initial annual payout would be around USD 85 million under the proposed allocation compared with around USD 55 million for the current asset allocation and 65 million for the 60/40, based on the estimated real return at a 70 percent confidence level and EA NAV of USD 9.3 billion as of September 2021.

**Figure 7. Illustrative Alternative Portfolios for the EA**  
**7.a. Risk and Return Profile of EA Alternative Portfolios over a Long-term Horizon**



**7.b. Asset Allocation of EA Alternative Portfolios**



Sources: ORTEC and staff analysis, end-September 2021.

### C. Investment Arrangements

**16. The EA was established with a ‘core-satellite’ structure.** Under this arrangement, the core of the EA has been invested passively pursuant to an asset allocation approved by the Board, while a limited portion of the portfolio, a satellite of no more than 10 percent, has been managed under an active strategy. The actively managed portion was initiated in 2016 with a targeted pilot allocation of five percent of the EA. The two managers selected for the pilot were given significant flexibility to take tactical asset allocation tilts and hold relatively concentrated portfolio positions. The goal for

this pilot allocation was to determine whether the active strategy could increase the likelihood of the EA achieving its return target over time, and more generally inform the evolution of the overall EA strategy.

**17. The experience with the pilot satellite has not established a supportive case for extending a broad active management approach.** As presented in June, staff's comparative analysis of the performance of the passive and active approaches did not establish a supportive case for broad active management across the EA.<sup>12</sup> Also, while the pilot for an actively managed allocation has been useful in informing the relative effectiveness of the EA's core passive strategy, the incremental information value from the pilot will likely diminish over time. In June, most Directors supported staff's proposal to discontinue the broad multi-asset active component and replace it with an alternative approach that would enable more targeted use of active management.

**18. Staff proposes replacing the 'core-satellite' model with a framework which would enable active management for selected asset classes.** In line with this proposal, the actively managed satellite would be discontinued. Under the new framework, the Board would determine the key characteristics of the investment approach to be followed for each asset class included in the EA. Decisions would be taken on which assets could be managed actively and which could be invested in private assets.<sup>13</sup> The Managing Director would have the authority to determine the scope and modalities for the investment approach following the Board's decisions. At the EA's establishment, the passive core of the portfolio was required to closely track benchmark indices selected by the Managing Director. This approach had two benefits, it enabled a very efficient implementation of the EA's target asset allocation and it helped to allay initial concerns around potential conflicts of interest. Passive management has proven to be very effective in general. However, experience gained in the implementation of the portfolio has highlighted compelling reasons to consider alternative approaches to passive index replication for certain asset classes (Figure 8). Going forward, the simple structure proposed by staff could accommodate a transparent evolution of the investment arrangements for different asset classes in the EA.

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<sup>12</sup> The return of the active pilot since inception in 2016 is slightly less than that of the passive strategy on a net of fees basis. In addition, performance tended to track the passive quite closely—deviations were driven by persistent differences in the allocation to two asset classes (EM equities and longer-dated corporate bonds) rather than active asset allocation tilts.

<sup>13</sup> With the exception of the infrastructure debt allocation which may be invested in private markets, the IA and TA are primarily invested in equities that are publicly listed and exchange traded, and in fixed-income instruments that are publicly traded through an established over-the-counter trading system. The Managing Director has permitted some investments that are not, strictly speaking, considered publicly listed or traded because, for example, the investments may only be purchased by institutional investors. However, these investments share certain key characteristics of publicly listed or traded securities, including liquidity profile, marketability to a broad investor base, and eligibility for an established exchange, and/or clearinghouse. Similarly, BIS instruments are available to its central bank, monetary authority, and international financial institution client base, but have long been permissible investments for the IA and TA. Accordingly, references in this paper to investments made in public markets should be understood to include investments similar to the foregoing. Other investments may also be considered public from time to time, taking into account market developments and other relevant facts and circumstances at the time of investment.

**Figure 8. Summary of Investment Approaches for EA's Asset Classes**

	<i>EA Asset Class</i>	<i>Investment Approach</i>	
Fixed-Income	Global sovereign bonds	Passive	Index-tracking
	Global corporate bonds	Passive	Rules-based
	Infrastructure debt	Passive	Buy-and-hold
Equities	US TIPS	Passive	Index-tracking
	Infrastructure equities	Passive (Proposed)	Index-tracking
	REITs	Passive	Index-tracking
	DM equities	Passive	Index-tracking
	EM equities	Active (Proposed)	

Note: All investments are in public markets except for infrastructure debt.

**19. Passive investment approaches continue to be effective and suitable for the EA's fixed-income allocations and would be maintained.** Passively replicating benchmark indices has proven to be an efficient way to gain market exposure for DM government bonds, EM bonds, and US TIPS. Recognizing the limitations of index replication for corporate bonds, the Board granted the Managing Director additional flexibility to determine modalities of appropriate passive approaches for individual asset classes in 2018.<sup>14</sup> With this flexibility, the IOC implemented a rules-based, buy-and-hold approach for investing in corporate bonds to overcome many of the weaknesses of replicating a market capitalization weighted index. Under this alternative passive approach, the returns from the corporate bond allocation are driven by a specified exposure to key risk factors while managers are given limited discretion to select individual securities. Finally, a passive buy-and-hold approach has been established for investing in private infrastructure debt in recognition that private investments have restricted marketability.<sup>15</sup> This approach was chosen to increase the likelihood of harvesting an illiquidity yield premium over time.

**20. While passive investment for DM equities remains an effective approach for the EA, staff recommends transitioning to active management for EM equities.** As discussed in detail in the initial paper, there are compelling potential benefits to active management for EM equities over the current approach of tracking a market capitalization weighted index.<sup>16</sup> Firstly, EM equity indices have several shortcomings and biases by construction, based on the judgments made by the index

<sup>14</sup> *Review of the Investment Account* (SM/18/24, 02/02/2018).

<sup>15</sup> Investments in private infrastructure debt have been implemented to date via private funds, which cannot be divested quickly.

<sup>16</sup> Box 2, *Review of the Investment Account and Trust Assets Investment Strategy—Initial Considerations* (FO/DIS/21/75, 05/19/2021).

providers in establishing rules for index inclusion. Secondly, staff's analysis indicates that active managers for EM equities can add value consistently over the return of market indices. This is not the case in DM equities where active managers tend to underperform. One reason often cited for this difference is that the greater information inefficiencies in EM markets give skilled equity managers more opportunity to add value through proprietary research. One further benefit to active management in EM equities is that it gives scope for more responsible investment. Staff envisages that the IOC would implement the transition to active management for the EM equities component gradually and the Board would be updated on the transition through the annual report.

**21. A passive investment approach continues to be suitable for the allocation to REITs and would be appropriate for initiating the new allocation to infrastructure equities.** Employing an index tracking approach for REITs and infrastructure equities would facilitate efficient and expedient implementation of the EA's proposed asset allocation changes. Staff's analysis confirms that the available public market indices for these asset classes offer considerable diversification in terms of sector and constituents and could serve as suitable benchmark strategies at this stage. Staff envisages that the IOC would review the existing REITs benchmark given the increased allocation to the asset class and consider indices with broader exposure to newer sectors, such as tech-related real estate, that have grown over the past few years. For infrastructure equities, the range of public market indices has also grown over the last decade. A broad, well diversified index with meaningful exposure to global core infrastructure sectors (e.g., utilities, transportation, communications) would serve as a suitable benchmark initially. Core infrastructure sectors generally have steady cash flows with a strong yield component, high barriers to entry, and inflation-linked revenues. These characteristics contribute to stable income and inflation protection through different business and economic cycles. In addition, investments in these sectors are expected to offer long-term, low-risk, non-correlated, and inflation-protected returns which are particularly suitable for the EA. Staff will continue to assess the potential benefits of active management and private investments for both of these asset classes and may seek the Board's approval for changes to the investment approach prior to the next 5-yearly review if warranted.

### Figure 9. Refinements for the EA Investment Strategy—Staff Proposals (I)

**The Board modifies the Strategic Asset Allocation and Investment Strategy as follows:**

- The EA shall be invested pursuant to the following Strategic Asset Allocation: 15 percent in global sovereign bonds; 10 percent in US TIPS; 15 percent in global corporate bonds; 5 percent in infrastructure debt; 25 percent in developed market equities; 10 percent in emerging market equities; 10 percent in infrastructure equities; and 10 percent in real estate investment trusts (REITs). (*IA Rules 128*)
- The 'core-satellite' structure consisting of a core passively managed portion and satellite actively managed portion will be discontinued and the actively managed portion (satellite) will be terminated. (*IA Rules 129*)
- Active management will be permitted for EM equities. (*IA Rules 129*)

**The Board modifies the limits on investment activities as follows:**

- Currency hedging will be permitted for fixed-income securities denominated in emerging market currencies. (*IA Rules 138*)

**The Board delegates the following additional implementation parameters to the Managing Director:**

- Scope and modalities for active management in the permitted asset classes. (*IA Rules 131*)

Additional technical updates to terminology in the IA Rules are proposed for alignment with the TA Guidelines.

## FIXED-INCOME SUBACCOUNT

### A. Background, Performance, and Recent Developments

**22. The FI's assets, which constitute the bulk of the Fund's precautionary balances, are invested to generate a reasonable income while providing protection to the Fund's balance sheet.** The expanded investment strategy for the FI established in 2015 was designed to support these dual purposes. At that time, the Fund's broadened investment authority enabled an expansion of eligible assets in line with general practices for investing reserves by peer investors.<sup>17</sup> In addition, the investment horizon was lengthened in light of the low risk of needing to draw on the FI resources and the challenge of generating income in a low interest rate environment. The investment objective of the FI was defined as achieving investment returns that exceed the 3-month SDR interest rate (SDRi) over time while minimizing the frequency and extent of negative returns and underperformance over an investment horizon of three to four years. Under the expanded investment strategy, assets in the FI were split in two tranches to make the portfolio more resilient in a broad range of market environments. Tranche 1 is a short duration, actively managed portfolio in which external managers can adjust risk exposure to duration and credit assets according to market

<sup>17</sup> Peer investors include central bank reserves managers and multilateral development banks.

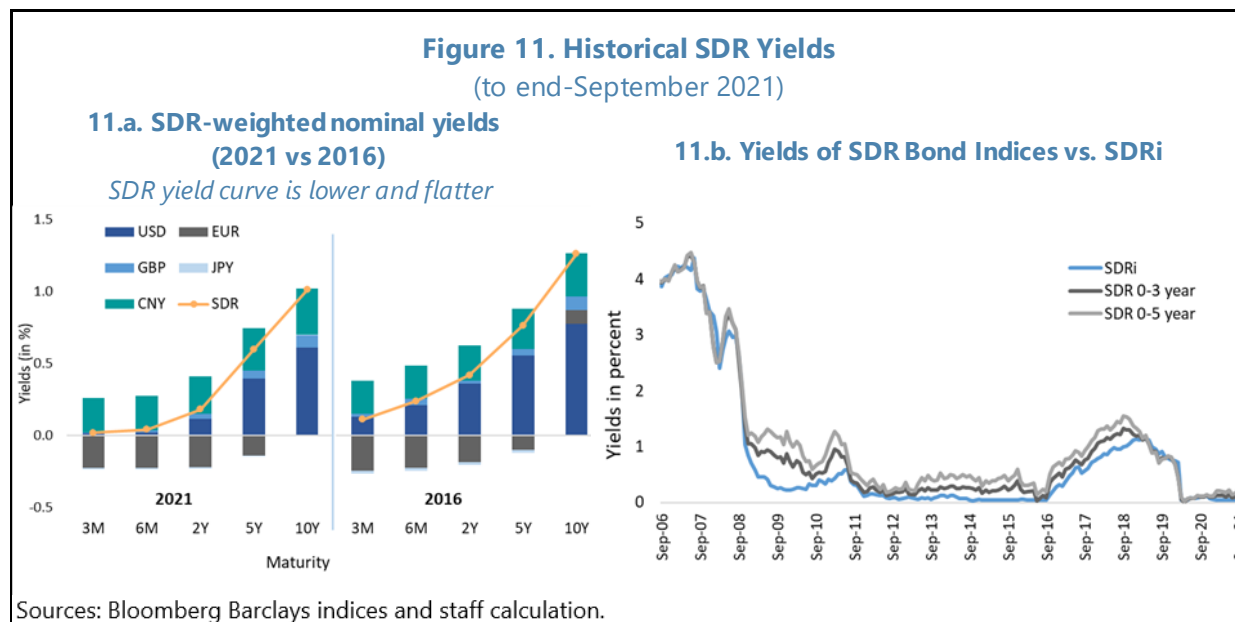
conditions; Tranche 2 consists of longer duration, buy-and-hold investments which were phased-in over five years (Figure 10).

**Figure 10. FI Strategy—Tranching and Eligible Assets**

	Limitations	Tranche 1	Tranche 2
<b>Features</b>		<b>Actively managed; short duration (0-3 years) 65 percent of total FI</b>	<b>Buy and hold investment strategy; longer duration (0-5 years); 35 percent of total FI</b>
<b>Group 1 Assets</b>		<u>SDR or SDR- Component currencies</u> Government bonds Bonds issued by national agencies of the members whose currencies are in the SDR basket Bonds issued by international financial institutions Bank for International Settlements (BIS) obligations	
<b>Group 2 Assets</b>	Limited to 35 percent of total FI	<u>SDR or SDR- Component currencies</u> Asset-backed securities Covered bonds Corporate bonds Cash instruments US Mortgage-backed securities Subnational government bonds Non-SDR Government bonds	
		Derivatives allowed for hedging	

**23. The expanded strategy was implemented effectively and has performed well in meeting its investment objective.** Since the strategy's inception, the return of the FI has exceeded the SDRi on an annualized basis by a solid margin of 45 bp (Annex V). The FI's return has also exceeded the old SDR 1-3 year benchmark and has been significantly superior on a risk adjusted basis, generating a return consistently in excess of the SDRi even during challenging market conditions (Box 2). The expanded set of assets and broader duration spectrum have been valuable sources of income and risk diversification. Effective implementation of the strategy has also contributed to the solid performance—balancing return generation potential and managing incremental risks from the expanded assets.

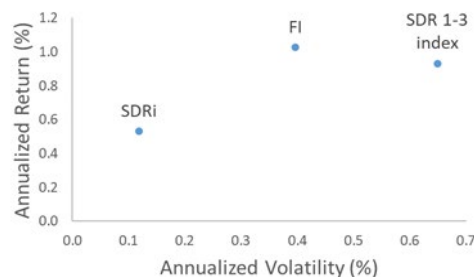
**24. Historically low yield levels and a flatter yield curve will limit future returns from short-dated fixed income.** SDR-weighted government bond yields fell into negative territory in the first quarter of 2020 at the onset of the COVID crisis, reaching new historical lows. Although they have since increased somewhat from those levels, SDR bond yields are still lower, and the yield curve is flatter than five years ago (Figure 11). Continued monetary stimulus could keep interest rates lower for longer, which will most certainly constrain future fixed-income returns and offer limited protection to bond investors when rates increase.



### Box 2. Expanded FI Strategy—Sources of Value Added

**The expanded FI strategy has performed well since its inception in 2016, generating an annualized return of about 1 percent and exceeding the SDRi by around 45 bp.** The broader universe of assets and expanded duration spectrum improved the FI’s risk adjusted returns. The strategy allowed for the balancing of credit risk premia and term premia to generate returns above the SDRi while containing risks. Since the implementation of the expanded strategy, the Sharpe ratio, which measures risk-adjusted performance, for the expanded FI strategy is 1.31, significantly higher than 0.63 for the previous strategy benchmark index (SDR 1-3).

**Figure 1. FI Strategy Return and Risk (from 2016)**



Source: State Street and Bloomberg data.

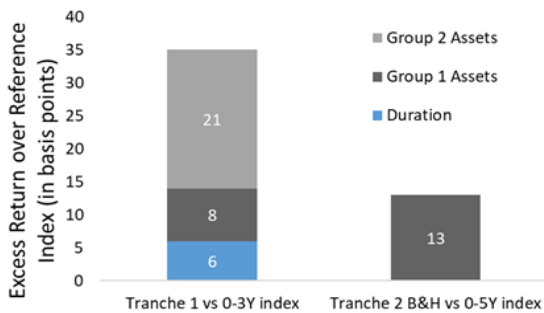
**Effective implementation has contributed to the solid performance of the FI strategy.** The IOC has overseen the implementation of the expanded strategy, including establishing risk controls, manager arrangements, Tranche 2 phase-in modalities, and setting the relative share of the two tranches. After the strategy had been in place for three years, the Committee conducted a comprehensive review of the experience with the expanded strategy and made several refinements to the initial implementation parameters.<sup>1/</sup> These refinements included adjusting the split between Tranches 1 and 2 to 65/35 from the initial 50/50 to better balance credit and term risk in the portfolio.<sup>2/</sup> In addition, the IOC adjusted manager arrangements and recalibrated some risk controls to accommodate the new tranche split as well as improve operational modalities. The FI’s cumulative performance since then has been 20 bp higher than it would have been otherwise. In addition, managers selected for Tranche 1 have performed well and had a positive impact on diversification—the volatility of overall Tranche 1 returns is lower compared to most of the individual managers.

**Box 2. Expanded FI Strategy—Sources of Value Added (Concluded)**

**The flexibility for external managers to invest in an expanded set of assets in Tranche 1 has been a valuable source of income and risk diversification.** Compared with the strategy benchmark of the SDR 0-3 year government bond index for Tranche 1, staff analysis of performance since inception indicates that more than half of Tranche 1 returns in excess of the reference index were attributable to Group 2 credit assets (Figure 2). Group 2 credit assets have become a core component of Tranche 1 manager strategies for generating positive risk premia and providing income protection in periods of rising rates, consistent with the benefits envisaged at the time the strategy was established (Figure 3). Group 1 assets have also added value in both Tranche 1 and 2 although by a smaller amount, as expected.

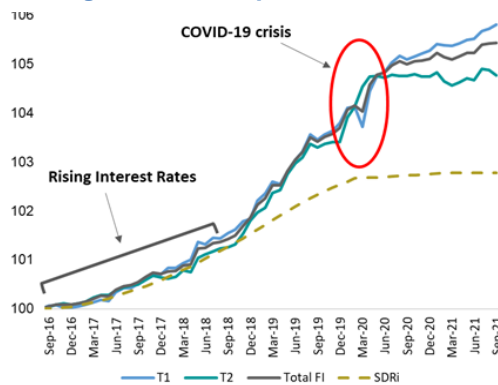
**In addition, the expanded duration spectrum has provided further opportunity to manage risk and enhance returns.** The flexibility afforded to Tranche 1 managers to invest within a duration range of 0-2.5 years was well utilized to manage risk when interest rates rose in 2017-2018. This flexibility in duration management in Tranche 1 is estimated to have generated an excess return of about 6 bp per annum relative to the SDR 0-3 year government bond index (Figure 2). In addition, the longer duration of Tranche 2 has strengthened FI resilience during periods of falling rates, such as following the outbreak of the COVID-19 pandemic and can contribute higher income from term premium in environments with stable upward sloping yield curves (Figure 3). It is worth noting that as the completion of the phase-in of Tranche 2 longer duration investments has extended the overall duration of the FI, the income protection and diversification benefits of Group 2 assets will become even more important in the balancing of credit and risk premia going forward.

**Figure 2. Estimated Excess Return over Reference Index**



Source: Staff analysis based on performance of FI tranches relative to various SDR government bond indices (including duration matched indices).

**Figure 3. FI Performance by Tranche (August 2016 to September 2021)**



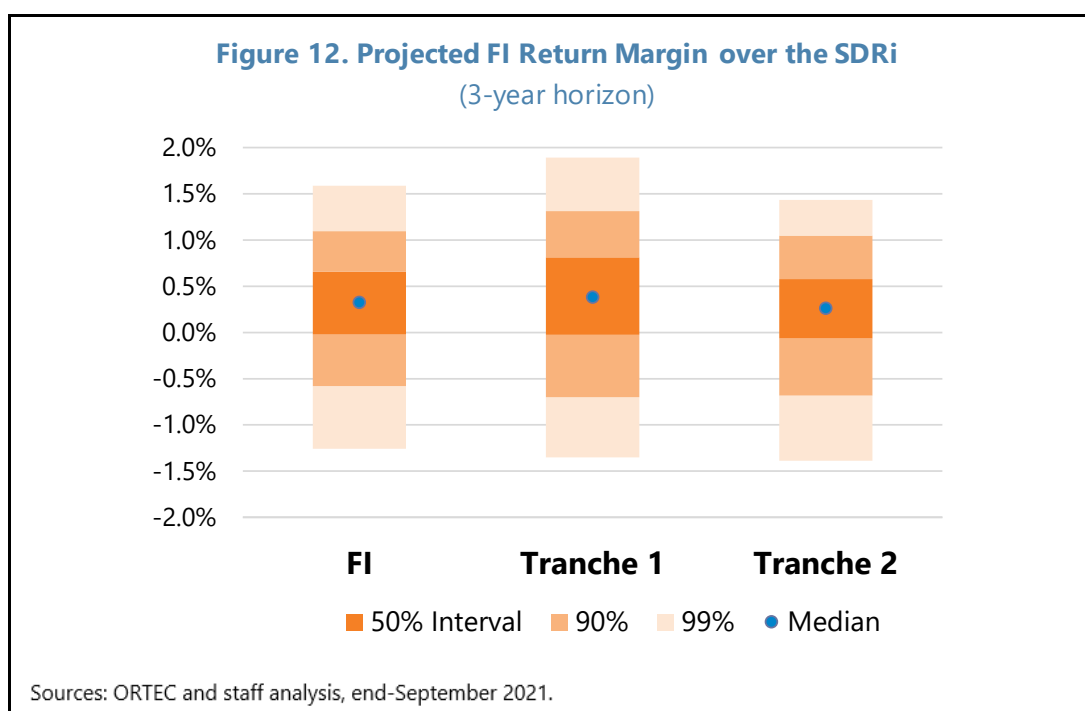
Source: State Street and Bloomberg data.

1/ Annual Report of the Investment Account and Trust Accounts for FY2020 (EBS/20/134, 07/27/2020).

2/ The share of Group 2 assets in the FI increased marginally after changing the tranche split, however, it remained below the allowable limit due to different manager strategies and fewer opportunities in certain markets and rating segments.

## B. Investment Objectives and Strategy

**25. Under the current interest rate environment, the FI's return margin over the SDRi is projected to be lower, but still positive, going forward.** Based on model portfolio simulations, the FI strategy is expected to exceed the SDRi over a three to four-year horizon by an average margin of 32 bp. The likelihood of exceeding the SDRi is estimated to be around 76 percent.<sup>18</sup> Return margins for Tranche 1 are projected to be slightly higher than for Tranche 2, reflecting additional risk premia from the broader set of eligible assets (Figure 12). While the current strategy is expected to remain resilient across a broad range of market conditions, the risk of underperforming the SDRi increases under certain stress scenarios (e.g., sustained negative interest rates or sharply rising interest rates) (Annex VI).



**26. Staff proposes some incremental refinements to the FI strategy to improve potential performance without materially altering the subaccount's overall risk profile.** The proposed refinements are as follows: (i) lower the minimum eligible credit rating threshold; (ii) marginally increase the Group 2 assets limit; (iii) delegate the selection of Tranche level benchmarks to the Managing Director as part of overall risk controls; and (iv) refine the definition of two eligible asset classes to enable more efficient investment operations. The first three refinements were discussed by the Board in June and Directors expressed preliminary support for them. These refinements build on the experience with the expanded FI strategy and are in line with the direction taken by peer

<sup>18</sup> The proximity of interest rates to the 5 bp SDR interest rate floor also increases the risk of underperforming the SDR interest rate and lowers the projected return margin.

investors.<sup>19</sup> Responding to requests from some Directors, additional clarification on the implementation of the proposed refinements, including envisaged risk controls, is discussed below and more detailed quantitative analysis is provided in Figure 13 and Annex VI. The fourth refinement addresses some technical clarifications which will enable more efficient investment operations. In conjunction with adopting a numerical long-term return target, which staff also proposes below, these refinements can fine tune the FI strategy to better meet its dual objectives.

### ***Refinement 1—Lower the Minimum Eligible Credit Rating Threshold***

**27. To broaden the investment universe, staff recommends lowering the minimum eligible credit rating threshold from single-A to BBB- for corporate bonds and to BBB+ for all other assets.** As experience has shown, the flexibility to invest in a broader range of assets—particularly Group 2 credit assets—has been a valuable source of income and risk diversification. However, holdings of Group 2 assets to date have been somewhat below the allowable 35 percent limit. This is partly explained by corporate issuance trends, which have limited the number of eligible issuers in the single-A and above segment. Managers have confirmed that the ability to invest in BBB corporate bonds would meaningfully broaden the opportunity set. Portfolio diversification would also be enhanced through access to a significantly greater number of issuers, most notably through non-financial issuers in non-cyclical, defensive industries that are typically more resilient to economic downturns. Overall, the expansion of the opportunity set would improve managers' ability to maintain well-diversified allocations of Group 2 assets even as the size of the FI increases in the future.

**28. Suitable risk controls would be put in place to ensure that the FI maintains a high overall credit quality.** Several safeguards are already available to limit potential credit risks; these include the ability for the Managing Director to set higher minimum ratings for specific asset classes, rules for divestment of securities that cease to meet the rating threshold, and strict concentration limits for sectors and issuers. These provisions allow the IOC, acting on behalf of the Managing Director, to differentiate credit exposure thresholds across asset classes in manager level guidelines. In addition, permitted issuer concentration can vary by asset and credit rating. Currently, corporate bond issuer exposure limits are 1.5 percent for bonds rated AA- or below, and 2.5 percent for bonds with higher credit ratings. Staff envisages that the IOC would establish additional risk controls to limit incremental credit risk from expanding into BBB-rated securities, in line with earlier experience in implementing the expanded investment universe for the FI. For example, a maximum market value limit on BBB-rated securities of say 10 percent of Tranche 1 would help to maintain the average credit quality of the portfolio above single-A. In addition, the IOC will include a higher minimum credit rating for corporate securities of BBB+ initially in manager guidelines. Staff will inform the Board if the IOC decides to adjust this minimum credit rating in the future.

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<sup>19</sup> According to recent surveys, peer investors have been looking to enhance returns by diversifying into a broader range of fixed-income instruments and employing more active risk management.

***Refinement 2—Marginally Increase the Group 2 Assets Limit***

**29. Increasing the Group 2 assets limit from 35 to 40 percent would provide valuable additional flexibility to Tranche 1 managers and potentially improve the balance of credit and term risk premia in the FI.** The recent decision by the IOC to adjust the split between Tranche 1 and Tranche 2 to 65/35 has been beneficial to the overall FI performance. However, a tighter limit for Group 2 assets had to be imposed on the Tranche 1 managers to implement the increased allocation to Tranche 1. A slightly higher limit for Group 2 assets in the FI overall would provide room for the IOC to reestablish higher limits for the Tranche 1 managers. This would enable managers to adjust Group 2 holdings and pursue broader diversification across assets. Overall Group 2 holdings would likely increase but remain somewhat below the allowable limit in practice. Experience has shown that Tranche 1 managers take different approaches to investing in credit assets. Their allocations to Group 2 assets can vary substantially and be well below the allowable limit on average.<sup>20</sup> The increased flexibility provided by the slightly higher limit will enable more diversification across manager strategies, which has proven to be a valuable source of risk reduction in Tranche 1 to date. Also, a slight increase in Group 2 assets overall would potentially improve the balance of credit and term risk premia in the FI now that the phase-in of Tranche 2 longer duration investments has been completed.

***Refinement 3—Delegate the Selection of Tranche-Level Benchmarks to the Managing Director and Establish a Maximum Duration Limit in the IA Rules***

**30. To enhance implementation efficiency and agility, staff recommends that the selection of tranche-level benchmarks be delegated to the Managing Director as part of overall risk controls.** The FI's benchmarks are currently stipulated in the IA Rules, unlike for the EA where benchmark selection has been delegated to the Managing Director. The delegation of benchmark selection for the FI would provide the IOC, acting on behalf of the Managing Director, further flexibility to refine implementation parameters for each portfolio tranche under different interest rate regimes. For example, if interest rates were to rise in the future to more normal levels, it would be beneficial to consider increasing exposure to term premia by expanding the duration of the FI. This could be achieved by adjusting the split between the two tranches in favor of Tranche 2, which has a longer duration benchmark. Similarly, this could be achieved by increasing the duration of the Tranche 2 benchmark while maintaining the tranche split. This latter approach may be more effective and operationally efficient since it would not disrupt manager arrangements. The additional flexibility to modify the term of the SDR benchmarks would enable the IOC to manage the balance between term and credit risk premia under different interest rate regimes. Major regime shifts are infrequent, so it is very unlikely that the IOC would actively change benchmark terms, and any changes would be reported to the Board as part of annual reporting. However, as has been demonstrated by the IOC's refinement of the tranche split, the flexibility to make these occasional

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<sup>20</sup> The current Group 2 exposure as percent of the overall FI is 23 percent, somewhat below the 35 percent limit. As a percent of Tranche 1, the exposure by managers ranges between 21 and 55 percent.

implementation changes in a timely manner is important to the overall performance of the FI strategy.

**31. To ensure that the strategic risk profile of the FI is maintained, staff would recommend that this delegation of responsibility is constrained by the addition to the IA Rules of a limit to portfolio duration of 3 years.** This limit would represent a moderate increase from the current implied maximum FI duration of around 2.5 years, based on the current tranche level benchmarks and allowable deviations. It would ensure that any changes to benchmark terms made by the IOC are implementation refinements rather than material changes to the FI's interest rate risk profile.

#### ***Refinement 4—Technical Refinements to the Definition of Two Eligible Asset Classes***

**32. Technical refinements to the definitions of two eligible asset classes are recommended to enable more efficient investment operations.** Firstly, it is recommended that the IA Rules refer to “debt obligations issued by supranational institutions” in place of “debt obligations of international financial institutions.” The term “international financial institution” is not widely recognized in financial markets whereas “supranational” is a market-standard classification which covers broadly the same type of institutions.<sup>21</sup> Under the supranational classification, managers could refer to recognized third-party benchmark providers to determine eligible issuers—as they do for other asset classes.<sup>22</sup> Secondly, it is recommended that national agency bonds include those issued by national agencies of all member countries that meet the rating criteria and are denominated in the SDR basket currencies.<sup>23</sup> These refinements would marginally expand available investment opportunities without materially altering the risk and return profile of the FI, since new assets made eligible by these changes would be similar in nature to existing assets in these sectors and would still need to satisfy the credit rating thresholds and other limits in place.

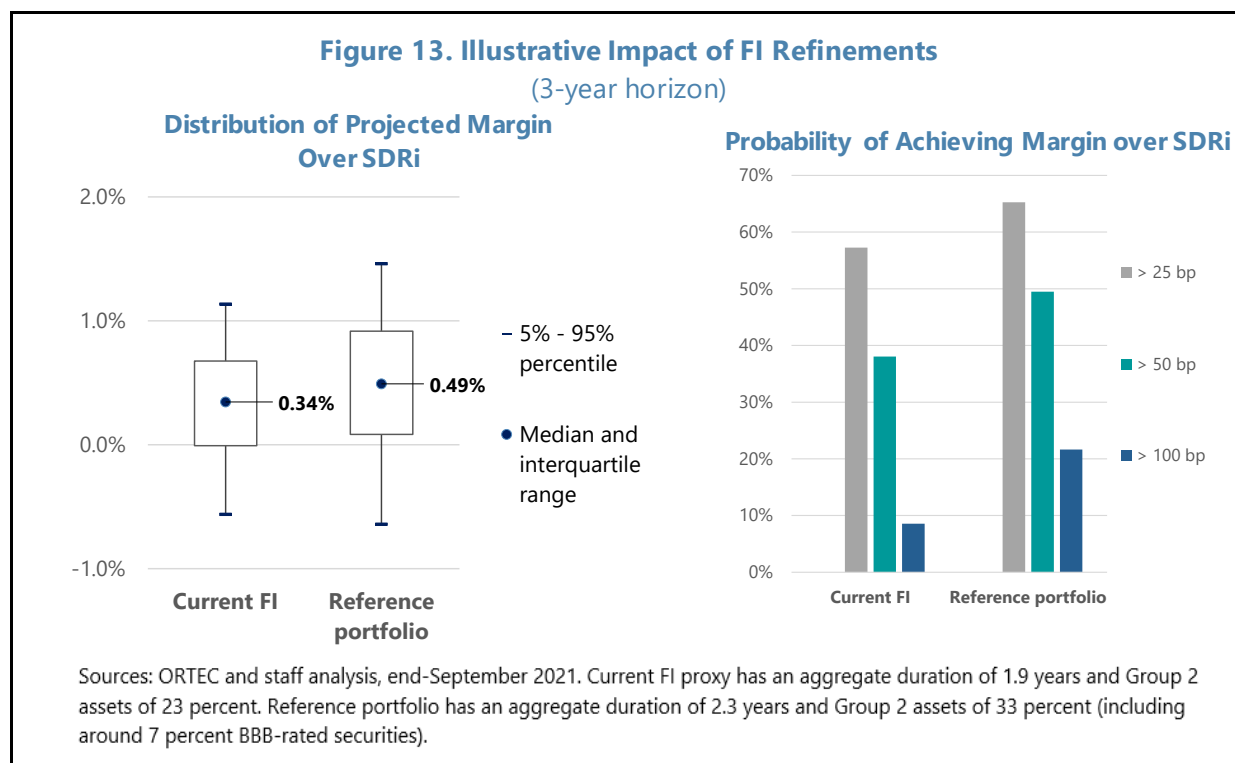
**33. Taken together, these refinements would improve the prospects of achieving a 50 bp margin over the SDRi without materially increasing portfolio risk.** Responding to requests from Directors, staff conducted additional analysis on the impact of the proposed refinements. The analysis compares the current FI portfolio with an illustrative reference portfolio which incorporates the proposed strategy refinements. The incremental increase in term and credit risk premia in the reference portfolio improves its probability of achieving a given margin over the SDRi over a 3-year horizon and helps to maintain a balanced risk profile. The proposed portfolio is also expected to perform better than the current portfolio under stress scenarios as shown in Annex VI.

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<sup>21</sup> Bloomberg Barclays includes supranational issuers as part of the government-related sector group encompassing issuers with government affiliations (Agencies, Sovereign, Supranational and Local Authority). The supranational sector covers international organizations whose stakeholders extend beyond a specific nation.

<sup>22</sup> Currently, staff has to maintain a list of eligible IFIs in investment management agreements with managers, which is cumbersome to update.

<sup>23</sup> Currently, only debt obligations issued by national agencies of the members whose currencies are in the SDR basket are permitted. This definition is unnecessarily restrictive and operationally difficult for some managers in practice.



**34. Establishing a numerical target in the IA Rules for the expected return margin above the SDRi could be useful to guide expectations for the FI strategy’s risk and return profile.**

Staff proposes setting an initial target margin of 50 bp on average above the SDRi. A 50 bp margin would seem to be a reasonable long-term expectation, consistent with the experience from the FI strategy thus far and assuming the proposed incremental strategy refinements are adopted. Forward-looking portfolio simulations also suggest that even in the current low interest rate environment the refined FI strategy could achieve a 50 bp margin. It should be recognized though that over the shorter term (e.g., 3 years or less) the return margin will vary depending on the level and path of interest rates. However, adding the return target to the existing investment objectives would clarify the desired risk and return profile for the FI and serve as a useful guide for implementation of the strategy. A higher margin, as envisaged under the NIM, could be revisited in future reviews and when yield curves have returned to levels which were more normal in the past.

### Figure 14. Refinements for the FI Investment Strategy—Staff Proposals (II)

**The Board modifies the investment objective as follows:**

- The investment objective will be to achieve investment returns in SDR terms that exceed the 3-month SDR interest rate by around 50 bp on average over time while minimizing the frequency and extent of negative returns and underperformance over an investment horizon of three to four years. (IA Rules ¶116)

**The Board establishes the following with respect to asset allocation and tranches:**

- The FI shall have a maximum average duration of three years. (IA Rules ¶117)

**The Board modifies the maximum Group 2 assets limit as follows:**

- The maximum Group 2 assets limit shall be 40 percent of total FI (35 percent previously). (IA Rules ¶119)

**The Board modifies the minimum credit rating as follows:**

- The minimum credit rating for eligible assets shall be equivalent to at least BBB- (S&P long-term rating scale) for corporate bonds, and BBB+ for all other assets. (IA Rules ¶121)

**The Board delegates the following additional implementation parameters to the Managing Director:**

- The selection of benchmark indices for Tranche 1 and 2 as part of overall risk controls. (IA Rules ¶117)

**The Board modifies the eligible assets definitions as follows:**

- The term “supranational” will replace “international financial institution.” (IA Rules ¶118)
- National agencies issued by all member countries would be permitted. (IA Rules ¶118)

Additional technical updates to terminology in the IA Rules are proposed for alignment with the TA Guidelines.

## TRUST ASSETS—PRGT

### A. Background, Performance, and Recent Developments

**35. The PRGT’s investment objectives established in 2017 are aligned with its self-sustaining financial framework.** The return target for the Trust’s investments is to generate an average annual margin of 90 bp above the SDR interest rate over a long-term horizon of at least 10 years. The PRGT’s financial framework enables the Trust’s investment assets to be invested over a long horizon to generate sufficient sustainable income to cover subsidization requirements and administrative expenses.<sup>24</sup> It was estimated in 2017 that at the time a long-term investment return of 90 bp above the SDR interest rate could support a self-sustained lending capacity for the PRGT of

<sup>24</sup> Investment assets include assets in the PRGT Reserve and Subsidy Accounts.

SDR 1.25 billion per year on average. In addition to generating income to support the PRGT's self-sustaining operations, the Trust's investment assets must also provide security to its lenders and adequate liquidity in case of arrears.<sup>25</sup>

**36. A moderately diversified strategy was adopted to achieve these investment objectives without taking on undue risks.** This strategy allocates 45 percent of the PRGT's investment assets to high-quality short duration fixed-income (SDFI) and liquidity components, with the remaining balance invested in longer-term asset classes which carry higher risk premia, specifically, corporate bonds, EM bonds and global equities. The longer-term assets have higher return potential over long horizons, albeit with greater volatility of returns and risk of losses over shorter periods. The implementation of the new strategy was phased over three years, ending in December 2020. During the transition period, the performance of the longer-term asset classes benefited considerably from supportive market conditions—especially for equities—while the impact of market volatility through the COVID-19 crisis was also somewhat mitigated by the diversified strategy and the phased implementation. The portfolio has generated an annualized return of 3.11 percent since inception of the new strategy, 248 bp above the SDR interest rate (Annex V). While the performance to date has exceeded the return target by a large margin, it is too early at this stage to fully evaluate the effectiveness of the new strategy.

**37. The outcome of the recent *Review of Concessional Finance and Policies* provides important context for possible refinements to the PRGT's current investment objectives and strategy.**<sup>26</sup> The Board approved a two-stage funding strategy to cover the resource costs created by pandemic-related PRGT lending while preserving the long-term sustainability of the endowment-based financing model. The funding strategy also seeks to reinforce adequate reserve coverage during the first (crisis-lending) stage, including through the establishment of the new Subsidy Reserve Account (SRA) which will provide an additional backstop to the PRGT Reserve Account and subsidy accounts. A post pandemic review to consider a long-term solution to PRGT self-sustainability is planned for the second stage, to take place in 2024/2025. Given exceptional near-term uncertainty surrounding projections of lending and of financing needs for low-income countries, resource adequacy would be monitored closely in the event an earlier review becomes necessary, especially if costs of lending increase.

**38. A new Deposit and Investment Account (DIA) has also been established to facilitate large scale contributor investments for the benefit of the PRGT.** The DIA will allow members to channel SDRs (or currencies) for generating investment income. This income can be used as PRGT subsidy resources or transferred to the SRA to supplement the Trust's reserves. Establishing a separate account for such contributor resources will facilitate large scale investments for the benefit

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<sup>25</sup> These functions are assigned to the PRGT's Reserve Account which currently constitutes about half of the PRGT's total investment assets. Income earned on the Reserve Account will be used for subsidization of lending when subsidy resources are fully exhausted.

<sup>26</sup> *Fund Concessional Financial Support for Low-Income Countries—Responding to the Pandemic* (SM/21/120, 06/30/2021).

of the PRGT and enable new investment alternatives to be offered, building on the components of the PRGT strategy and its investment platform.

## B. Investment Objectives and Strategy

### 39. Staff propose maintaining the PRGT's target return margin of 90 bp above the SDRi for the time being, based on the following considerations.<sup>27</sup>

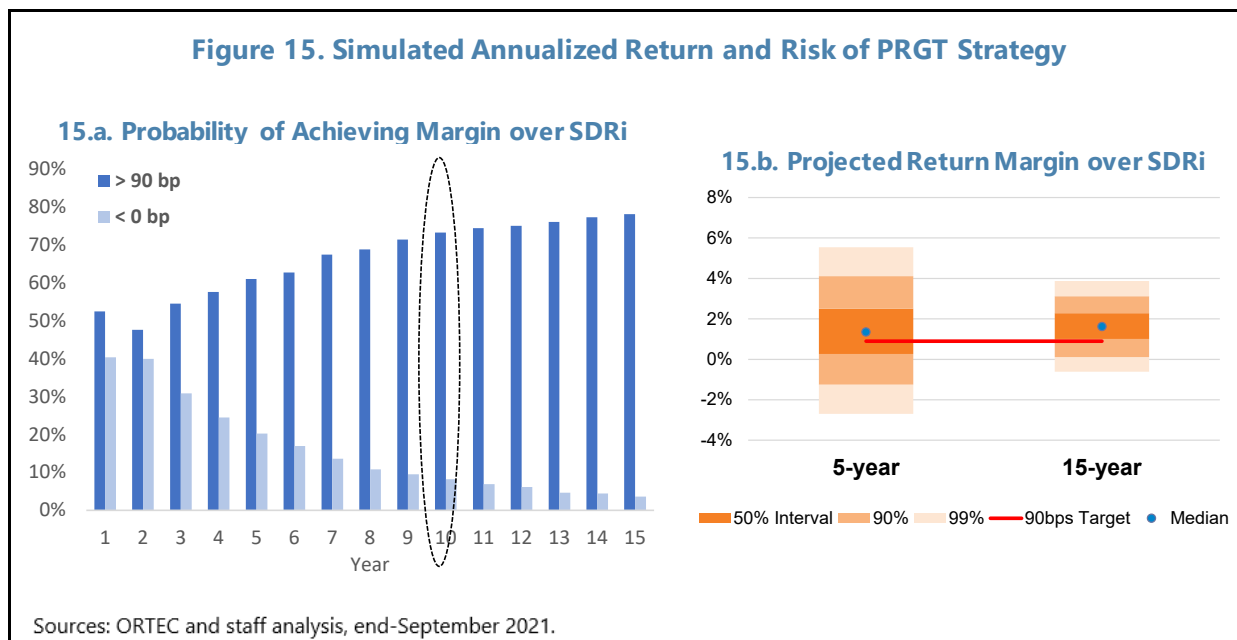
- i. The current investment objectives remain appropriate and are consistent with preserving the long-term sustainability of the PRGT's financial framework. Under this framework, PRGT's aggregate assets, including assets in the new SRA, can continue to be invested with a long-term investment horizon to generate income for subsidization requirements and future administrative expenses. Achieving the current target margin of 90 bp above the SDRi would enable a post crisis self-sustained lending capacity of SDR 1.65 billion per year, as envisaged in the *Fund Concessional Financial Support for Low-Income Countries—Responding to the Pandemic*.<sup>28</sup>
- ii. The return target is still achievable with the PRGT's moderately diversified investment strategy. It does not require an increased allocation to longer-term assets to reach the return target over the investment horizon. While absolute returns for most asset classes are expected to be lower than in the past, market risk premia remain sufficient for PRGT's current strategy to achieve a margin of 90 bp above the SDRi with a reasonably high degree of confidence. Staff's analysis estimates a 73 percent probability that the existing strategy will exceed this margin over a 10-year horizon with a mean projected return of 156 bp above the SDRi over the long run (Figure 15). The estimated return variability and downside risks of the PRGT's moderately diversified strategy over this period remain tolerable given the long-term investment horizon and adequate reserves coverage. It should be noted though that short-term variability and downside risk are higher—for example, the probability that the investment return will fall below the SDRi on an annual basis is now estimated at around 40 percent (Figure 15a).
- iii. The surge in PRGT lending has resulted in a decline in reserves coverage below the historical level of 40 percent, with a possible further decline in the coming years as demand for lending is expected to remain exceptionally high. During the June 2021 informal discussion, Directors expressed general support for maintaining the existing risk profile for the PRGT investment strategy in light of broader discussions on the PRGT's financial framework and the declining reserve ratio. As discussed in June, increasing the risk profile of the investment strategy to achieve a higher return target would increase portfolio risks and potentially undermine the important reserve function of the assets at a time when the reserve coverage

<sup>27</sup> As discussed in the June paper, the reference SDR interest rate in the investment objectives will be updated from the 6-month to the standard 3-month rate (SDRi) to reflect the uniform remuneration rate recently agreed by lenders. The impact of this change is de minimis.

<sup>28</sup> SM/21/120, June 30, 2021.

is declining. Estimated worst-case losses on the current investment strategy could reduce the reserve coverage ratio by an additional 3 percent over a 10-year horizon. Staff views this risk as tolerable but does not see room for increasing the risk profile of the investment strategy at this time.

- iv. The return target and risk profile of the investment strategy could be revisited around the time of the second stage of PRGT’s funding strategy in 2024/2025, taking into account any material changes to the PRGT’s self-sustaining financial framework.



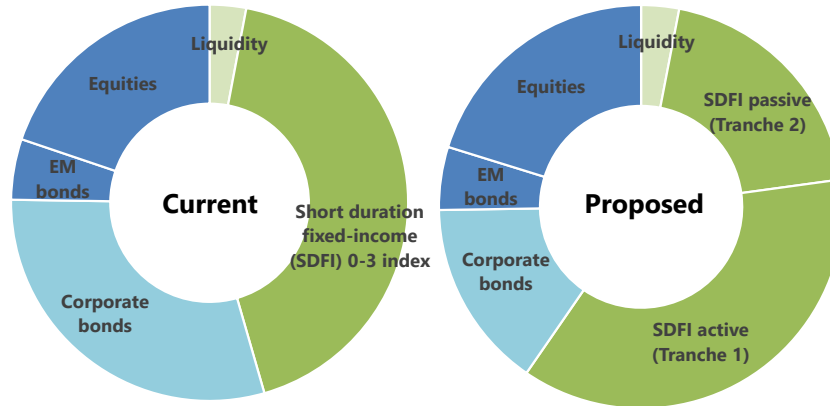
**40. Refining the investment approach for the SDFI component could improve portfolio resilience without materially changing the overall return outlook for PRGT.** The SDFI component moderates the volatility of the overall portfolio and enhances the portfolio’s reserve-like qualities, providing security to lenders. These are important functions in the current environment of exceptionally high demand for lending. In addition, if interest rates were to increase more rapidly than expected from the current historically low levels, the PRGT’s subsidy resources would be run down faster than base case forecasts. For these reasons, it is sensible to insulate the investment portfolio against the risk of interest rate rises if this does not reduce return expectations materially. To this end, staff propose increasing the core allocation to SDFI assets by 15 percent—through a reduction in the allocation to longer-dated corporate bonds—and modifying the investment of the SDFI component to replicate the FI strategy.<sup>29</sup> This well-established strategy has served the Fund, and thereby members, well. Experience with the FI suggests that its two-tranche approach would make the SDFI component more resilient to changes in the interest rate environment and generate additional return through diversification across an expanded set of fixed-income assets and active

<sup>29</sup> Staff envisages that the IOC would implement the strategy for the SDFI component with substantially similar risk controls and sector limits as those in place for the FI.

management.<sup>30</sup> As shown in Figure 16, increasing the allocation to the refined SDFI component and liquidity components from 45 to 60 percent and reducing the global corporate bond allocation improves the risk versus return profile of the overall PRGT strategy under the baseline scenario. Staff analysis also shows that the refined strategy is more resilient in scenarios of rising interest rates, given its lower allocation to long-dated corporate bonds (Annex VI).

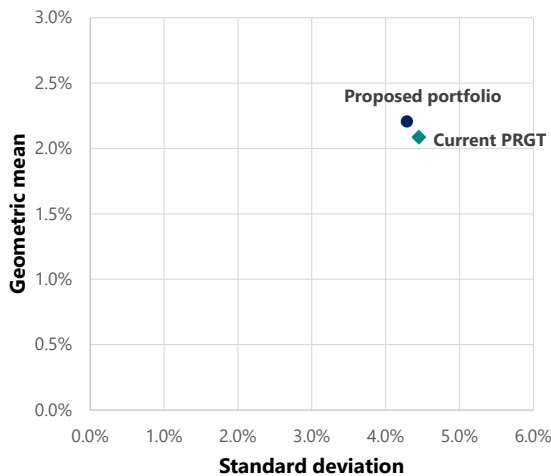
**Figure 16. Illustrative Impact of Refinements to PRGT Target Asset Allocation**

**Figure 16a. Current and Proposed Asset Allocation**

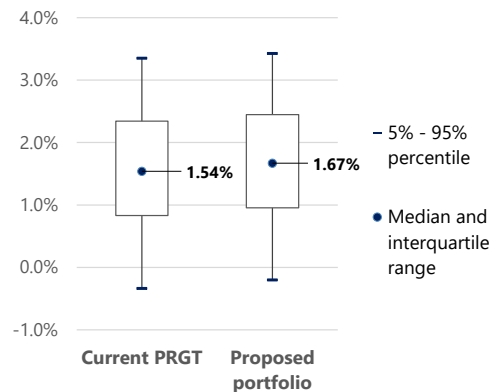


**Figure 16b. Illustrative Impact of PRGT Strategy Refinements (10-year horizon)**

**Risk and Return Profile of PRGT Asset Allocations**



**Distribution of Projected Margin Over SDRi**



Sources: ORTEC and staff analysis, end-September 2021. The current FI portfolio and two-tranche structure is used as a proxy for the SDFI component in the PRGT proposed portfolio.

<sup>30</sup> In line with the FI strategy, the refined SDFI component would have two tranches.

**41. As discussed with Directors in June, further refinements are proposed to maintain the alignment in implementation of PRGT investments with the IA.** Specifically, staff proposes to align the PRGT equity component with the EA's equity allocation, and allow active management for EM equities.<sup>31</sup> Also, staff envisages that the IOC will modify the implementation of the corporate bond allocation to include EM issuers.<sup>32</sup> These refinements will align the investment of both these asset classes with EA, and for the reasons described earlier in the EA section they are expected to improve potential portfolio return. The rebalancing policy will also be aligned with the one approved for the EA in 2019.<sup>33</sup>

### Figure 17. Refinements to the PRGT Investment Strategy—Staff Proposals (III)

**The Board modifies the PRGT's investment objective as follows:**

- Generate a long-term margin of 90 bp above the *3-month* SDR interest rate over a long-term investment horizon (at least 10 years). The change in SDR interest rate from the 6-month to 3-month rate is to align with the uniform remuneration rate agreed by lenders in FY2021. (*TA Guidelines* ¶13)

**The Board modifies the target asset allocation and eligible investments as follows:**

- The target allocation for the corporate bond component will be 15 percent (from 30 percent). (*TA Guidelines* ¶14)
- The target allocation for the liquidity and SDFI components will be 60 percent (from 45 percent). (*TA Guidelines* ¶14)
- The SDFI component will be managed in line with the investment strategy for the FI (as described in the IA Rules). (*TA Guidelines* ¶16)
- The equities component shall continue to be managed passively, except for emerging market equities which may be managed actively. (*TA Guidelines* ¶21)

Additional technical updates to terminology in the TA Guidelines are proposed for alignment with the IA Rules.

**42. To improve the investment choices available to contributors to the PRGT, especially for the DIA, staff propose to offer the strategy for the SDFI component described earlier as an additional stand-alone investment option** (Figure 18). Two investment alternatives are currently permissible for PRGT contributor investments, namely, (i) investments pooled with PRGT assets and benefiting from the PRGT's overall long-term investment strategy, and (ii) investments in short-

<sup>31</sup> Through this proposal, "publicly listed equities" will be replaced by "global equities" in the TA Guidelines in order to recognize, in line with the EA, that public investments are not always, strictly speaking, "publicly listed" as described in ¶18 and footnote 13.

<sup>32</sup> Under the TA Guidelines, the Managing Director has been delegated the authority to establish the parameters for determining specific assets eligible for the corporate bond component.

<sup>33</sup> *The Investment Account – Introducing Private Fixed Income in the Endowment Subaccount* (SM/19/80, 04/12/2019).

dated BIS instruments.<sup>34</sup> As a third option, contributor investments could be pooled with PRGT assets in the SDFI component, which could be an attractive alternative for contributors. In particular, the strategy for the SDFI component would be aligned with that of the Fund's own reserves in the FI, and its role in generating income while enhancing the reserve-like properties and resilience of PRGT assets may offer desirable features for many contributors' investments. Apart from the reserve-like assets that the strategy is invested in, the relatively short investment horizon (around 3-4 years) also helps to minimize the risk of permanent impairment of capital in the event of an unexpected withdrawal (e.g., encashment). The strategy also has a proven track record, generating a consistent return in excess of the SDRi of around 45 bp per annum over the last five years. The existing two investment alternatives and this new SDFI investment option will be made available to contributors that provide resources for investment to generate earnings for the accounts of the PRGT, including the DIA.<sup>35</sup>

#### Figure 18. Refinements to Guidelines for the Investment of Temporary Resources to Generate Income to Contribute to the PRG Trust—Staff Proposals (IV)

The Board establishes the following modification to the guidance for the investment of contributor resources for the PRGT:

- The strategy for the PRGT SDFI component will be offered as an additional standalone investment option for all contributor resources being invested to generate investment income for the PRGT.

## OTHER TRUST ASSETS

### A. Background, Recent Developments, and Investment Strategy

**43. The investment objectives for the CCRT and PRG-HIPC Trust reflect the purposes of the underlying assets and varying liquidity requirements of each trust.** During the 2017 review, the Board reaffirmed that such resources should be invested to support the primary purpose of safety and liquidity, to ensure assets are available for disbursement when needed. The investment objective for these assets is to enhance returns subject to the liquidity requirements of each trust and limiting the risk of impairment of capital over the investment horizon (up to three years). As both the events and amounts required for CCRT assistance are highly uncertain, CCRT balances have been maintained in liquid BIS deposits since the trust's inception. PRG-HIPC Trust balances—

<sup>34</sup> Few contributors to date have expressed interest in selecting the PRGT's long-term investment strategy, while BIS instruments offer limited potential to generate meaningful subsidy resources. For example, rolling 3-month BIS deposits would have generated only 5 bp above the official SDR interest rate over the past 5 years.

<sup>35</sup> Contributor resources may be pooled with PRGT investment assets. A clear attribution of the relative share of invested assets to the various accounts of the PRGT will be maintained in line with the current practice. Specifically, under the current record keeping arrangements, detailed attribution is made of the share of each PRGT account in the investments. Moreover, FIN maintains a share allocation record of individual contributor's share of net income earned on their investment, and their share in remaining resources of a PRGT account in the event of termination, e.g., winding up of the PRGT. Such share calculation will allow for monitoring of the estimated value of each contributor's investment in the DIA.

consisting of surplus balances for previously estimated HIPC debt relief—are invested in both the liquidity component (deposits) and investment component which comprises high-quality short duration fixed-income instruments.

**44. A relatively short investment horizon continues to be appropriate for both the CCRT and the PRGT-HIPC Trust investable assets; no changes to the current investment strategy are recommended.** There have been no changes to the financial structure of these trusts that would have implications on the suitability of the current investment strategy. In addition, recent developments confirm that the nature of these assets and the significant uncertainty about future decisions and resource needs would not justify a longer investment horizon than currently in place (i.e., no more than three years). For the CCRT, available balances remain very small in relation to potential disbursement requirements and fundraising efforts are currently underway. For the PRGT-HIPC Trust, additional debt relief is expected to be disbursed through the trust in the coming years—two countries are expected to reach their completion point by mid-2024 and one country is still at pre-decision point. After the completion of debt relief payments, the eventual transfer of surplus balances to the PRGT would depend on future policy decisions by the Board. Against this backdrop, staff do not see a need to propose refinements to the current investment objectives and strategy for other trust assets.

**45. Staff continue to evaluate potential investment arrangements that could support the formation of the new Resilience and Sustainability Trust (RST) that is under consideration.** In general, the broad range of investment strategies and existing arrangements in place for the PRGT and other TA can be adapted to suit the distinct requirements of the new trust. Furthermore, if these strategies could be implemented as pooled investments, this would incur significantly lower investment costs than for separately managed accounts due to scale economies.<sup>36</sup> In addition, the established process in place for record-keeping and return attribution for various trust accounts would maintain appropriate separation of assets. The recommended investment strategy and arrangements will be included as part of the forthcoming RST proposal.

## RESPONSIBLE INVESTING

**46. Based on Directors' earlier guidance, staff proposes that the Board formalize a commitment to responsible investing for the IA and TA in the IA Rules and the TA Guidelines, respectively.**<sup>37</sup> This commitment would be established with a requirement for the Managing Director to maintain a principles-based policy for responsible investing (the "Principles") and to consult with the Executive Board on any material changes to responsible investing objectives and arrangements. The Principles would provide clear guidelines for the implementation of responsible

<sup>36</sup> Pooling of trust assets for investment purposes is a common practice followed by multilateral development banks such as the World Bank and Inter-American Development Bank.

<sup>37</sup> See IA Rules ¶¶6-8 and TA Guidelines ¶¶4-6.

investing practices and enable these practices to evolve over time, as industry standards emerge.<sup>38</sup> As the IA Rules and the TA Guidelines are public documents, this commitment would communicate externally the institutional importance of responsible investing. For the Board's reference, the key elements for the Managing Director's Principles are discussed below and a preliminary draft is included in Annex VII.

**47. The Principles would establish how responsible investing supports the IA's and TA's financial objectives and upholds the Fund's reputation.** The aim of responsible investing—through incorporating environmental, social, and governance (ESG) considerations in the investment process—is to identify portfolio risks and opportunities with the aim of improving long-term income generation and risk mitigation. Under the Principles, investment practices would continue to focus on the integration of ESG considerations in external managers' investment processes and on responsible ownership practices that impact corporate behavior to generate sustainable value. Evaluation of managers' ESG policies and processes would remain a key part of the initial selection process and ongoing oversight. However, the Principles will now allow for distinct responsible investment requirements to be incorporated in managers' investment mandates. This would establish the expectation that managers would be assessed on their capabilities for identifying ESG opportunities and risks in line with industry best practices.

**48. The Principles would be sufficiently flexible to ensure that practices can evolve over time.** Directors supported existing practices, as presented in *Responsible Investing for the Investment Account and Trust Assets* but agreed that they would need to advance.<sup>39</sup> In addition to ESG integration and effective corporate engagement, practices would also seek to identify new opportunities and incorporate investment practices that contribute towards positive climate and societal impact. Under the Principles, implementation could remain agile in responding to these new opportunities and practices. The Principles would also permit limited norms-based exclusions to address rare cases where an investment is highly controversial and poses excessive reputational risk or indeterminate financial risk that cannot be mitigated by corporate engagement. Directors supported delegating the authority to establish limited exclusions to the Managing Director based on clear criteria and widely accepted standards.<sup>40</sup> In line with industry best practice, the Principles would also enable the Fund to support broad industry initiatives that advance responsible investment through industry collaboration. Staff's annual reporting to the Board on responsible investing would be developed further to ensure accountability and transparency with the Principles and industry best practice.

<sup>38</sup> Based on the Board's earlier discussion considering the merits of establishing an institution-wide commitment, several discussions between FIN and INV staff explored this possibility. At this time, both have plans to formalize ESG-related policy commitments, but are doing so separately given their respective governance processes.

<sup>39</sup> *Responsible Investing for the Investment Account and Trust Assets*, Supplement 1 (FO/DIS/21/75, 5/19/2021).

<sup>40</sup> The process would follow accepted practice for minimizing perceptions of conflicts of interest and facilitate an agile response to emerging reputational risks.

## CONFLICTS OF INTEREST

**49. The Fund is committed to avoiding actual or perceived investment-related conflicts of interest.** Such conflicts could arise from the actual or perceived misuse by the Fund of non-public information from its surveillance, financing, or capacity development activities to benefit its investment activities, or from non-public information about its investment activities being used to influence the Fund's other activities. Actual or perceived conflicts could also arise through the misuse by an individual for personal gain of such non-public Fund information.

**50. The accompanying paper, *Review of the Conflict of Interest Framework for the Investment Account and Trust Assets*, reviews the Fund's experience with its conflict of interest framework.** The IA Rules and TA Guidelines each require that the Executive Board review the Fund's relevant conflict of interest policies every five years. In this review, staff view that the framework for personal conflicts of interest has continued to serve the Fund well and, accordingly, no refinements are recommended. For the review of the framework for institutional conflicts, staff engaged in a benchmarking exercise that found the Fund to be well placed among its peers but that the institutional conflicts framework could nevertheless benefit from some refinements.

**51. One area of potential refinement to the institutional conflicts framework relates to the role of the Designated Officer.** This component of the "management oversight" structural element of the conflicts framework could be strengthened by Management to more closely align it with peers' compliance functions. While being mindful of the Ethics Office's resources and competing demands, specific potential improvements include: (i) removing the "interim" characterization of the Ethics Advisor in this role; (ii) formalizing the role through promulgation of terms of reference by Management; (iii) strengthening the Ethics Advisor's and ETOs capabilities with institutional conflicts through training; and (iv) implementing measures to proactively monitor for potential institutional conflicts.

**52. Another potential refinement to the institutional conflicts framework is to adopt clear, bright-line rules, where appropriate, rather than rely on contextual and subjective analysis.** While the Fund's approach of contextual analysis has performed well to evaluate conflict of interest risks with investment proposals, it stood out among peers, all of whom favored bright-line rules such as asset exclusions or geographic restrictions to mitigate actual and perceived conflict of interest risk, particularly for assets having a close nexus to the peer's core functions. In performing the peer benchmarking, staff saw the benefits of clear rules, namely that they reduce the scope for subjectivity and that they facilitate easy assessments of compliance. For example, staff see merit in a clear rule that would identify and apply restrictions to asset classes with a direct nexus to the Fund's core work, such as sovereign bonds, as they are more likely to raise risks of perceived or actual conflicts of interest.

**53. If Directors are supportive of the refinements set out in the accompanying paper, clear and bright-line rules could be developed by the IOC.** In accordance with the IA Rules and TA Guidelines, the IOC is empowered by the Managing Director to develop further rules to

appropriately address the prospect that some investments may give rise to increased risks of conflicts of interest. These rules could be similar to some already in effect for assets having a close nexus to the Fund, such as the credit rating threshold for sovereign bonds to reduce the likelihood of investing in bonds of members receiving Fund financial assistance.

**54. This review also evaluates the investment proposals set out in this paper and determines that none of them give rise to conflict of interest risks that cannot be effectively mitigated.** A number of proposals make minor modifications to existing asset classes, such as changes to allocation percentages, and therefore do not give rise to new conflicts of interest concerns. Further analysis of other proposals which add or modify asset classes shows that they too do not result in unmitigable risk of perception of conflict:

- a. **Infrastructure equities in the EA.** This asset class is not among the types of assets which have been linked in the current framework to giving rise to heightened risk of perception of conflict. Moreover, the new allocation to these publicly traded assets will be managed externally—external management has been identified as strongly guarding against perceptions that the Fund is improperly using non-public information to benefit its investments.<sup>41, 42</sup>
- b. **Active management of EM equities in the EA.** The current framework considers that securities whose markets are still developing and relatively illiquid could pose a perceived conflict risk. Factually, emerging markets have become considerably more liquid since 2008 when the sector was first analyzed. Also, this asset class will employ external management, which has been identified as a key mitigator of perception of conflict. That the external managers will be specialized in EM equities should not detract from the mitigating benefits of external management because specialized managers for EM equities are widely embraced by peer investors.
- c. **Supranationals in the FI.** The broadening of the current asset class permitting investment in the bonds of “international financial institutions” to instead cover “supranationals” could still permit investment in institutions which have loan programs similar to the Fund’s. However, this refinement should reduce the risk of perception of conflict because the universe of eligible issuers will be determined by a third party by reference to index sector classifications. From a conflict-mitigation

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<sup>41</sup> It is also proposed that infrastructure equities will initially be managed passively following public market indices. The current conflicts framework considers passive management as a strong mitigator against perceptions of conflict of interest. However, as discussed in the accompanying paper, *Review of the Conflict of Interest Framework for the Investment Account and Trust Assets*, staff now view that passive management is less important as a conflicts mitigator than previously envisioned.

<sup>42</sup> Staff further considers that, applying the proposed refinements to the Fund's conflicts of interest framework set forth in the accompanying paper, *Review of Conflict of Interest Framework for the Investment Account and Trust Assets*, the infrastructure equities asset class would not have a clear nexus to the Fund, which would not provide direct services or financing to infrastructure projects. Such a nexus might exist for some development bank peers, which might offer such services in connection with an infrastructure project.

perspective, this contrasts favorably with the Fund's current approach whereby the Fund specifies for external managers the list of eligible issuers.

- d. **Broadening the issuer base of national agencies in the FI so that it includes all members and not only those whose currencies are in the SDR basket.** The continued use of external management for this asset class should effectively mitigate perception that the Fund is directing the purchase of debt of specific national agencies. Furthermore, the credit rating threshold as proposed to be modified in this paper (BBB+) will make it unlikely that the Fund will be investing in the debt of national agencies in members receiving Fund financing.

## ISSUES FOR DISCUSSION

**55. The proposed amendments to the IA Rules and TA Guidelines are set out in Annex I through IV.** These changes may be approved the Executive Board by a 70 percent majority of the total voting power before being implemented by the Managing Director.

**56. Directors may wish to comment on the following issues:**

- a. Do Directors support staff proposals to refine the EA investment strategy along the lines of Figure 9?
- b. Do Directors support staff proposals to refine the FI investment strategy along the lines of Figure 14?
- c. Do Directors support staff proposals to refine the PRGT investment strategy along the lines of Figure 17 and to add another investment option for PRGT contributor investments as described in Figure 18?
- d. Do Directors support staff proposals to formalize a commitment to responsible investing in the IA Rules and the TA Guidelines as described in paragraphs 46 through 48?
- e. Do Directors support the refinements to the conflicts of interest framework as set forth in paragraphs 51 through 53?

## Proposed Decisions

The following decisions, which may be adopted by a seventy percent majority of the total voting power, are proposed for adoption by the Executive Board. Decision 3 is proposed for adoption only in the event that Decision 2 is adopted by the Executive Board.

### **Decision 1 – Amendment to the Rules and Regulations for the Investment Account**

The Rules and Regulations for the Investment Account, adopted under Decision No. 15314-(13/16), January 23, 2013, as amended, are further amended as set forth in the Annex I of SM/21/206.

### **Decision 2 – Amendment to the Guidelines for Investing PRG, PRG-HIPC and CCR Trust Assets**

Pursuant to Section VII, paragraph 3 of the Instrument to Establish the Poverty Reduction and Growth Trust, annexed to Decision No. 8759-(87/176) ESAF, adopted December 18, 1987, as amended, Section IV, paragraph 1 of the Trust for Special Poverty Reduction and Growth Operations for the Heavily Indebted Poor Countries and Interim ECF Subsidy Operations, annexed to Decision No. 11436-(97/10), adopted February 4, 1997, as amended, Section IV, paragraph 1 of the Instrument to Establish the Catastrophe Containment and Relief Trust, annexed to Decision No. 14649-(10/64), adopted June 25, 2010, as amended, and Article V, Section 12(h) of the Articles of Agreement, the Fund amends the Guidelines for Investing PRG, PRG-HIPC, and CCR Trust Assets as set forth in the Annex III of SM/21/206.

### **Decision 3 – Amendment to the Decision on Investment of Temporary Resources to Generate Income to Contribute to PRG, PRG-HIPC, and CCR Trusts**

Paragraph 1(b) of Decision No. 16253-(17/70), adopted July 28, 2017, shall be amended to read as follows:

“b. Contributor resources being invested to generate income for contributions to a Trust may be invested either:

- (i) in the same manner as the investment assets of the Trust, subject to the provisions applicable to the investment of these assets, as provided under the guidelines for Investing PRG, PRG-HIPC and CCR Trust Assets approved by the Executive Board in Decision No. [\_\_\_\_]-22/[\_\_\_\_], adopted [\_\_\_\_, 2022] and as may be amended from time to time (“Trust Guidelines”), or
- (ii) in obligations of the Bank for International Settlements (BIS), subject to the same provisions under the Trust Guidelines that apply to the investment assets of the Trusts being invested in BIS obligations, or
- (iii) with respect to resources invested to generate income for contributions to the PRG Trust, in the same class of high-quality short duration fixed-income assets that a component of the investment assets of the PRG Trust is invested in accordance with the Trust Guidelines.”

## Annex I. Rules and Regulations for the Investment Account

### I. GENERAL PROVISIONS

#### Objective of the Investment Account

1. The objective of the Investment Account (IA) is to provide a vehicle for the investment of a part of the Fund's assets so as to generate income that may be used to meet the expenses of conducting the business of the Fund. Achieving this objective would help diversify the sources and increase the level of the Fund's income, thereby strengthening its finances over time.

#### Sources of Investment Account Assets

2. The IA may be funded with: (a) currencies transferred from the General Resources Account (GRA) in accordance with Article XII, Section 6(f)(ii) of the Articles; (b) the placement of profits from the sale of pre-Second Amendment gold in accordance with Article V, Section 12(g) of the Articles, in amounts up to the total amount of the Fund's general and special reserves at the time of any decision authorizing such transfers; (c) the transfer of profits from the sale of post-Second Amendment gold in accordance with Article V, Section 12(k) of the Articles; and (d) income from the IA investment that is not transferred to the General Resources Account to meet the expenses of the Fund (Article XII, Section 6(f)(iv)).

#### Investment Account Subaccounts

3. The IA shall have a Fixed-Income Subaccount and an Endowment Subaccount, each of which has its own investment objective and shall be managed in accordance with Sections I and II, and I and III, respectively, of these Rules and Regulations (Rules).

4. Transfers of assets between subaccounts may be made with the approval of the Executive Board.

#### Responsibilities of The Managing Director

5. The Managing Director is responsible for implementing the investment policies set out in these Rules.

6. In carrying out the Managing Director's responsibilities, the Managing Director shall (a) establish effective decision-making and oversight arrangements; (b) take the necessary measures, including the adoption of policies and procedures, that seek to avoid actual or perceived conflicts of interest; (c) adopt responsible investing principles to incorporate environmental, social, and governance (ESG) considerations into the investment process to support the investment objectives of the IA and to uphold the Fund's reputation; and (d) establish specific risk control measures and put in place mechanisms to monitor their observance by asset managers.

7. The Managing Director shall consult with the Executive Board regarding the key conflict of interest policies and arrangements, and responsible investment principles and arrangements, in the Managing Director's responsibility referred to in paragraph 6.

8. The Managing Director shall provide annual reports to the Executive Board on the investment activities of the IA. Ad hoc reports shall be prepared as warranted by market or other developments.

### **External Asset Managers**

9. All assets of the IA shall be managed by external asset managers, except that the Managing Director is authorized to manage: (a) investments in obligations of the Bank for International Settlements (BIS) and central bank deposits; and (b) other assets on an interim basis following the termination of an external asset manager and pending the transfer of the assets to another external asset manager.

10. The Managing Director shall only select external asset managers of the highest professional standards and shall take into account their proven skills and track record suitable to achieve the investment objectives and to carry out the investment strategies set out under these Rules.

### **Custody Arrangements**

11. The Managing Director shall establish adequate measures for the safekeeping and custody of the assets of the IA.

### **Use of Investment Account Income**

12. The income from investment shall be invested, retained in the IA or used to meet the expenses of conducting the business of the Fund. The Fund shall decide on the use of the IA's income for each financial year, including whether any portion of such income will be transferred to the GRA for use in meeting the expenses of conducting the business of the Fund.

### **Termination or Reduction of The Investment Account**

13. The IA shall be terminated in the event of a liquidation of the Fund and may be terminated, or the amount of the investment may be reduced, prior to the liquidation of the Fund, by a 70 percent majority of the total voting power. The procedures specified in Article XII, Sections 6(f)(vii), (viii) and (ix) of the Articles will apply in the event of the termination of the IA or a reduction in its assets. The Fund's decision to reduce investments in the IA shall specify the subaccount from which assets shall be used to fund a reduction in investments.

### **Audit**

14. The assets of the IA shall be audited by the Fund's external auditors and included in the Fund's annual financial statements.

### **Review of The Rules and Conflict of Interest Policies**

15. The Executive Board is expected to review these Rules and the Fund's relevant conflict of interest policies every five years.

## **II. FIXED-INCOME SUBACCOUNT**

### **Investment Objective**

16. With a view of generating income while protecting the Fund's balance sheet, the investment objective of the Fixed-Income Subaccount is to achieve investment returns in SDR terms that exceed the 3-month SDR interest rate by a margin of 50 basis points over time while minimizing the frequency and extent of negative returns and underperformance over an investment horizon of three to four years.

## Asset Allocation and Tranches

17. (a) The Fixed-Income Subaccount shall consist of two tranches, a shorter-duration Tranche 1 and a longer-duration Tranche 2, and shall have a maximum average duration of 3 years.
- (b) Tranche 1 assets shall be managed actively. Eligible asset classes for Tranche 1 are Group 1 and Group 2 asset classes as defined in paragraph 18 below.
- (c) Tranche 2 assets shall be managed according to a buy-and-hold investment approach. Eligible asset classes for Tranche 2 are Group 1 asset classes as defined in paragraph 18 below.
- (d) Asset transfers between Tranche 1 and Tranche 2, and the allocation to Tranche 1 and Tranche 2 of future inflows to, and outflows from, the Fixed-Income Subaccount shall be determined by the Managing Director.

## Eligible Investments

18. (a) "Group 1 asset classes" shall be limited to:
- i. debt obligations issued by national governments of members or their central banks;
  - ii. debt obligations issued by national agencies of members;
  - iii. debt obligations issued by supranational institutions; and
  - iv. obligations issued by the BIS, including without limitation deposits with the BIS and MTIs;
- all of which shall be denominated in SDR or the currencies included in the SDR basket.
- (b) "Group 2 asset classes" shall be limited to:
- i. debt obligations issued by national governments of members or their central banks denominated in non-SDR currencies selected by the Managing Director or, upon the authorization by the Managing Director, by external managers, provided that any currency selection shall be based on ex-ante criteria determined by the Managing Director;

ii. debt obligations denominated in SDR or the currencies included in the SDR basket, comprising: (A) securities issued by subnational governments; (B) mortgage-backed and other asset-backed securities; (C) covered bonds; and (D) short-dated unsecured corporate bonds; and

iii. cash-equivalent investments with maturities of one year or less, that are denominated in SDR or the currencies included in the SDR basket.

(c) The Managing Director shall establish the parameters for determining the eligible investments within the categories of the asset classes specified in this paragraph.

19. Up to the maximum 40 percent of the total value of the Fixed-Income Subaccount assets may be invested in Group 2 asset classes, and the breach of this limit shall require prompt action to bring the Fixed-Income Subaccount back within the established limit.

20. In addition to investing in Groups 1 and 2 asset classes, the Fixed-Income Subaccount may temporarily hold residual cash balances uninvested, or in short-term instruments sponsored by the custodian(s) or an affiliate.

### **Minimum Credit Rating**

21. Except for obligations of the BIS, central bank deposits, and cash balances invested in short-term instruments under paragraph 20, all assets in which the Fixed-Income Subaccount invests shall be subject to the following minimum credit ratings by a major credit rating agency at the time of acquisition (based on Standard & Poor's long-term rating scale): (a) BBB- for corporate bonds; and (b) BBB+ for remaining assets. The Managing Director may establish higher credit ratings for eligible individual asset classes.

22. In cases where an asset is not directly rated, the Managing Director may determine whether a credit rating may be inferred for such asset in a manner that is consistent with market practice.

### **Divestment**

23. Any eligible investment that ceases to meet the rating threshold under paragraph 21 or otherwise becomes ineligible after acquisition shall be divested within three months, except that

corporate bonds which fail to meet the rating threshold under paragraph 21 after acquisition may be divested or continue to be retained in accordance with modalities established by the Managing Director.

### **Limits on Investment Activities**

24. The Managing Director shall establish adequate safeguards against short selling and financial leverage.

25. The exchange rate risk for eligible investments denominated in non-SDR currencies shall be hedged back into SDR basket currencies with the objective to preserve the Fixed-Income Subaccount's SDR basket composition. Currency hedging may be used for SDR basket replication or for achieving overall currency exposure in line with SDR basket.

26. Derivatives may be used for managing interest rate risk, currency hedging, or reducing costs in the context of portfolio balancing, benchmark replication, and market access.

### **III. ENDOWMENT SUBACCOUNT INVESTMENT OBJECTIVE**

27. The investment objective of the Endowment Subaccount is to achieve a long-term real return target of 3 percent in U.S. dollar terms. This is consistent with the objective of generating investment returns to contribute to the Fund's income, while preserving the long-term real value of these resources. The subaccount's real return shall be calculated by using the deflator that is used for purposes of the Fund's administrative budget, the Global External Deflator (GED), provided that the U.S. consumer price index (U.S. CPI) component of the GED shall be adjusted to use the actual U.S. CPI instead of the projected U.S. CPI.

### **Strategic Asset Allocation and Investment Strategy**

28. The Endowment Subaccount shall be invested pursuant to the following strategic asset allocation (SAA) benchmark: 15 percent in global sovereign bonds; 10 percent in U.S. Treasury Inflation-Protected Securities (US TIPS); 15 percent in global corporate bonds; 25 percent in developed market equities; 10 percent in emerging market equities; 5 percent in infrastructure debt; 10 percent in infrastructure equities; and 10 percent in real estate investment trusts (REITs).

29. Except for the allocation to emerging market equities, which may be managed actively, all Endowment Subaccount assets shall be managed passively.
30. Infrastructure debt investments may be made in private markets.
31. The Managing Director shall establish all parameters for determining eligible investments for the asset classes of the SAA and the modalities for appropriate investment approaches not otherwise specified herein.
32. The asset allocation benchmark shall not apply to residual cash balances temporarily held uninvested, or in short-term instruments sponsored by the custodian(s) or an affiliate.

### **Rebalancing**

33. Based on modalities established by the Managing Director, assets of the Endowment Subaccount shall be rebalanced at least annually to minimize deviation from the SAA benchmark specified in paragraph 28 above, or more frequently in the event of significant deviation.

### **Minimum Credit Ratings**

34. Except for uninvested cash balances invested in short-term instruments under paragraph 32, fixed-income assets in which the Endowment Subaccount invests are subject to the following minimum credit ratings by a major credit rating agency at the time of acquisition (based on Standard & Poor's long-term rating scale): (a) BBB- for corporate bonds and infrastructure debt, provided that the Managing Director may establish modalities for allowing limited investment in infrastructure debt that is rated below BBB- at time of acquisition; and (b) BBB+ for remaining assets.
35. In cases where an asset is not directly rated, the Managing Director may determine whether a credit rating may be inferred for such asset in a manner that is consistent with market practice.

### **Divestment**

36. Any eligible investment that ceases to meet the rating threshold under paragraph 34 or otherwise becomes ineligible after acquisition shall be divested within three months, except that corporate bonds and infrastructure debt which fail to meet the rating threshold under paragraph 34

after acquisition may be divested or continue to be retained in accordance with modalities established by the Managing Director.

### **Limits on Investment Activities**

37. The Managing Director shall establish adequate safeguards against short selling and financial leverage.

38. The exchange rate risk for fixed-income securities denominated in (a) developed market currencies vis-à-vis the U.S. dollar shall be hedged; and (b) emerging market currencies vis-à-vis the U.S. dollar may be hedged. Currency hedging is not permitted for other passively managed assets.

39. Derivatives may be used for managing interest rate risk, currency hedging operations required or permitted under paragraph 38, or reducing costs in the context of portfolio balancing, benchmark replication, and market access.

## Annex II. Redline of Rules and Regulations for the Investment Account

### I. GENERAL PROVISIONS

#### Objective of The Investment Account

1. The objective of the Investment Account (IA) is to provide a vehicle for the investment of a part of the Fund's assets so as to generate income that may be used to meet the expenses of conducting the business of the Fund. Achieving this objective would help diversify the sources and increase the level of the Fund's income, thereby strengthening its finances over time.

#### Sources of Investment Account Assets

2. The IA may be funded with: (a) currencies transferred from the General Resources Account (GRA) in accordance with Article XII, Section 6(f)(ii) of the Articles; (b) the placement of profits from the sale of pre-Second Amendment gold in accordance with Article V, Section 12(g) of the Articles, in amounts up to the total amount of the Fund's general and special reserves at the time of any decision authorizing such transfers; (c) the transfer of profits from the sale of post-Second Amendment gold in accordance with Article V, Section 12(k) of the Articles; and (d) income from the IA investment that is not transferred to the General Resources Account to meet the expenses of the Fund (Article XII, Section 6(f)(iv)).

#### Investment Account Subaccounts

3. The IA shall have a Fixed-Income Subaccount and an Endowment Subaccount, each of which has its own investment objective and shall be managed in accordance with Sections I and II, and I and III, respectively, of these Rules and Regulations (Rules).

4. Transfers of assets between subaccounts may be made with the approval of the Executive Board.

#### Responsibilities of The Managing Director

5. The Managing Director is responsible for implementing the investment policies set out in these Rules.

6. In carrying out the Managing Director's responsibilities, the Managing Director shall (a) establish effective decision-making and oversight arrangements; (b) take the necessary measures, including the adoption of policies and procedures, that seek to avoid actual or perceived conflicts of interest; (c) adopt responsible investing principles to incorporate environmental, social, and governance (ESG) considerations into the investment process to support the investment objectives of the IA and to uphold the Fund's reputation;<sup>[1]</sup> and ~~(d)~~ establish specific risk control measures and put in place mechanisms to monitor their observance by asset managers.

7. The Managing Director shall consult with the Executive Board regarding ~~(a)~~ the key conflict of interest policies and arrangements, and responsible investment principles and arrangements,<sup>[2]</sup> in the Managing Director's responsibility referred to in paragraph 6; ~~and (b) the key aspects of the investment strategy for the actively managed portion of the Endowment Subaccount referred to in paragraph 30 of these Rules~~<sup>[3]</sup>

8. The Managing Director shall provide annual reports to the Executive Board on the investment activities of the IA. Ad hoc reports shall be prepared as warranted by market or other developments.

### **External Asset Managers**

9. All assets of the IA shall be managed by external asset managers, except that the Managing Director is authorized to manage: (a) investments in obligations of the Bank for International Settlements (BIS) and central bank deposits; and (b) other assets on an interim basis following the termination of an external asset manager and pending the transfer of the assets to another external asset manager.

10. The Managing Director shall only select external asset managers of the highest professional standards and shall take into account their proven skills and track record suitable to achieve the investment objectives and to carry out the investment strategies set out under these Rules.

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<sup>[1]</sup> Inserted language reflects proposal in the paper (¶¶46-48) that the Board delegate to the Managing Director the authority to adopt responsible investment principles and arrangements.

<sup>[2]</sup> Inserted language reflects proposal in the paper (¶¶46-48) that the Board delegate to the Managing Director the authority to adopt responsible investment principles and arrangements.

<sup>[3]</sup> Deleted language reflects proposal in the paper (¶¶17-18 and Figure 9) that the core-satellite structure of the EA be discontinued, and that the Managing Director be delegated authority to determine implementation parameters.

### **Custody Arrangements**

11. The Managing Director shall establish adequate measures for the safekeeping and custody of the assets of the IA.

### **Use of Investment Account Income**

12. The income from investment shall be invested, retained in the IA or used to meet the expenses of conducting the business of the Fund. The Fund shall decide on the use of the IA's income for each financial year, including whether any portion of such income will be transferred to the GRA for use in meeting the expenses of conducting the business of the Fund.

### **Termination or Reduction of The Investment Account**

13. The IA shall be terminated in the event of a liquidation of the Fund and may be terminated, or the amount of the investment may be reduced, prior to the liquidation of the Fund, by a 70 percent majority of the total voting power. The procedures specified in Article XII, Sections 6(f)(vii), (viii) and (ix) of the Articles will apply in the event of the termination of the IA or a reduction in its assets. The Fund's decision to reduce investments in the IA shall specify the subaccount from which assets shall be used to fund a reduction in investments.

### **Audit**

14. The assets of the IA shall be audited by the Fund's external auditors and included in the Fund's annual financial statements.

### **Review of The Rules and Conflict of Interest Policies**

15. The Executive Board is expected to review these Rules and the Fund's relevant conflict of interest policies every five years.

## **II. FIXED-INCOME SUBACCOUNT**

### **Investment Objective**

16. With a view of generating income while protecting the Fund’s balance sheet, the investment objective of the Fixed-Income Subaccount is to achieve investment returns in SDR terms that exceed the 3-month SDR interest rate by a margin of 50 basis points<sup>[4]</sup> over time while minimizing the frequency and extent of negative returns and underperformance over an investment horizon of three to four years.

### Asset Allocation and Tranches

17. (a) The Fixed-Income Subaccount shall consist of two tranches, a shorter-duration Tranche 1 and a longer-duration Tranche 2, and shall have a maximum average duration of 3 years.<sup>[5]</sup>

(b) Tranche 1 assets shall be managed actively ~~against a 0–3 year government bond benchmark index, weighted to reflect the currency composition of the SDR basket. The Managing Director shall establish in the investment management agreements the permitted degree of active management against the benchmark.~~<sup>[6]</sup> Eligible asset classes for Tranche 1 are Group 1 and Group 2 asset classes as defined in paragraph 18 below.

(c) Tranche 2 assets shall be managed according to a buy-and-hold investment approach ~~against a 0–5 year government bond benchmark index, weighted to reflect the currency composition of the SDR basket, subject to subparagraph (e) below.~~<sup>[7]</sup> Eligible asset classes for Tranche 2 are Group 1 asset classes<sup>[8]</sup> as defined in paragraph 18 below.

(d) Asset transfers between Tranche 1 and Tranche 2, and the allocation to Tranche 1 and Tranche 2 of future inflows to, and outflows from, the Fixed-Income Subaccount shall be determined by the Managing Director.

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<sup>[4]</sup> Inserted language reflects proposal in the paper (¶¶33, 34 and Figure 14) that a numerical target be set for the Fixed-Income Subaccount.

<sup>[5]</sup> Inserted language reflects proposal in the paper (¶¶30, 31 and Figure 14).

<sup>[6]</sup> Deleted language reflects proposal in the paper (¶30 and Figure 14) that authority to select tranche-level benchmarks be delegated to the Managing Director.

<sup>[7]</sup> Deleted language reflects proposal in the paper (¶30 and Figure 14) that authority to select tranche-level benchmarks be delegated to the Managing Director.

<sup>[8]</sup> Clarification to align with defined term in paragraph 18(a) of the IA Rules.

~~(e) — The assets in Tranche 2 shall be phased over a five-year period, with the specific modalities of the phasing to be determined by the Managing Director. The phasing may be suspended or extended up to one year in case of exceptional market conditions.<sup>[9]</sup>~~

## Eligible Investments

18. (a) “Group 1 asset classes” shall be limited to:
- i. debt obligations issued by national governments of members or their central banks;
  - ii. debt obligations issued by national agencies of ~~the members whose currencies are in the SDR basket~~,<sup>[10]</sup>
  - iii. debt obligations issued by ~~international financial supranational~~<sup>[11]</sup> institutions; and
  - iv. obligations issued by the BIS, including without limitation deposits with the BIS and MTIs;
- all of which shall be denominated in SDR or the currencies included in the SDR basket.
- (b) “Group 2 asset classes” shall be limited to:
- i. debt obligations issued by national governments of members or their central banks denominated in non-SDR currencies selected by the Managing Director or, upon the authorization by the Managing Director, by external managers, provided that any currency selection shall be based on ex-ante criteria determined by the Managing Director;
  - ii. debt obligations denominated in SDR or the currencies included in the SDR basket, comprising: (A) securities issued by subnational governments; (B) mortgage-backed and

<sup>[9]</sup> Deleted language is no longer relevant given completion of phase-in period as noted in ¶22 of the paper.

<sup>[10]</sup> Revised language reflects proposal in the paper (¶32 and Figure 14) that national agency debt obligations denominated in SDR or SDR basket currencies of all members be eligible.

<sup>[11]</sup> Revised language reflects proposal in the paper (¶32 and Figure 14) to replace reference to “international financial institutions” with “supranational institutions”, which is a market-standard classification and covers broadly the same type of institutions.

other asset-backed securities; (C) covered bonds; and (D) short-dated unsecured corporate bonds; and

iii. cash-equivalent investments with maturities of one year or less, that are denominated in SDR or the currencies included in the SDR basket.

(c) The Managing Director shall establish the parameters for determining the eligible investments within the categories of the asset classes specified in this paragraph.

19. Up to the maximum ~~3540~~<sup>[12]</sup> percent of the total value of the Fixed-Income Subaccount assets may be invested in Group 2 asset classes, and the breach of this limit shall require prompt action to bring the Fixed-Income Subaccount back within the established limit.

20. In addition to investing in Groups 1 and 2 asset classes, the Fixed-Income Subaccount may temporarily hold ~~uninvested-residual~~ cash balances ~~uninvested, or including~~ in short-term instruments ~~of sponsored by~~ the custodian(s) ~~or an affiliate~~.<sup>[13]</sup>

### Minimum Credit Rating

21. Except for obligations of the BIS, central bank deposits, and ~~uninvested~~ cash balances ~~invested in short-term instruments under paragraph 20~~,<sup>[14]</sup> all assets in which the Fixed-Income Subaccount invests ~~must have a shall be subject to the following minimum~~ credit ~~rating equivalent to at least A (based on Standard & Poor's long-term rating scale) ratings~~<sup>[15]</sup> by a major credit rating agency at the time of acquisition ~~(based on Standard & Poor's long-term rating scale): (a) BBB- for corporate bonds; and (b) BBB+ for remaining assets~~.<sup>[16]</sup> The Managing Director may establish higher credit ratings for eligible individual asset classes.

22. In cases where an asset is not directly rated, the Managing Director may determine whether a credit rating may be inferred for such asset in a manner that is consistent with market practice.

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<sup>[12]</sup> Revised language reflects proposal in the paper (¶129 and Figure 14).

<sup>[13]</sup> Technical clarification to reflect prevailing practice more accurately.

<sup>[14]</sup> Technical clarification consistent with ¶120 of the IA Rules.

<sup>[15]</sup> This non-substantive change was made to promote consistency in terminology used in the IA Rules and TA Guidelines where appropriate.

<sup>[16]</sup> Revised language reflects proposal in the paper to lower the minimum eligible credit ratings (¶127 and Figure 14) and promotes consistency in terminology used in the IA Rules and TA Guidelines where appropriate.

## **Divestment**

23. Any eligible investment that ceases to meet the rating threshold under paragraph 21 or otherwise becomes ineligible after acquisition shall be divested within three months, except that corporate bonds which fail to meet the rating threshold under paragraph 21 after acquisition may be divested or continue to be retained in accordance with modalities established by the Managing Director.

## **Limits on Investment Activities**

24. The Managing Director shall establish adequate safeguards against short selling and financial leverage.

25. The exchange rate risk for eligible investments denominated in non-SDR currencies shall be hedged back into SDR basket currencies with the objective to preserve the Fixed-Income Subaccount's SDR basket composition. Currency hedging may be used for SDR basket replication or for achieving overall currency exposure in line with SDR basket.

26. Derivatives may be used for managing interest rate risk, currency hedging, or reducing costs in the context of portfolio balancing, benchmark replication, and market access.

## **III. ENDOWMENT SUBACCOUNT INVESTMENT OBJECTIVE**

27. The investment objective of the Endowment Subaccount is to achieve a long-term real return target of 3 percent in U.S. dollar terms. This is consistent with the objective of generating investment returns to contribute to the Fund's income, while preserving the long-term real value of these resources. The subaccount's real return shall be calculated by using the deflator that is used for purposes of the Fund's administrative budget, the Global External Deflator (GED), provided that the U.S. consumer price index (U.S. CPI) component of the GED shall be adjusted to use the actual U.S. CPI instead of the projected U.S. CPI.

## **Strategic Asset Allocation and Investment Strategy**

~~28. No less than 90 percent of the Endowment Subaccount assets shall be managed passively (the “passively managed portion”), with up to 10 percent of the Endowment Subaccount assets managed actively in accordance with paragraph 30 below (the “actively managed portion”).~~<sup>[17]</sup>

28. The Endowment Subaccount ~~The passively managed portion~~ shall be invested pursuant to the following strategic asset allocation (SAA) benchmark: 15 percent in ~~developed market global~~ sovereign bonds; ~~20~~10 percent in U.S. Treasury Inflation-Protected Securities (US ~~TIPS~~TIPS); 15 percent in ~~developed market global~~ corporate bonds; ~~5 percent in emerging market bonds~~; 25 percent in developed market equities; 10 percent in emerging market equities; 5 percent in infrastructure debt; 10 percent in infrastructure equities; and ~~5~~10 percent in real estate investment trusts (REITs).<sup>[18]</sup>

29. Except for the allocation to emerging market equities, which may be managed actively, all Endowment Subaccount assets shall be managed passively.<sup>[19]</sup>

30. Infrastructure debt investments may be made in private markets.<sup>[20]</sup>

31. The Managing Director shall establish ~~the all~~ parameters for determining eligible investments for the asset classes of the SAA and the modalities for appropriate ~~passive~~ investment approaches not otherwise specified herein.<sup>[21]</sup>

~~32. The actively managed portion may be invested only in the same asset classes as the SAA benchmark for the passively managed portion, with 60 percent in fixed-income instruments and 40 percent in equities (including REITs) and a permitted maximum deviation of ±15 percentage points for each category, but no specific allocation requirements for each asset class within these two~~

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<sup>[17]</sup> Deleted language reflects proposal in the paper (¶¶17, 18 and Figure 9) that the core-satellite structure of the EA be discontinued.

<sup>[18]</sup> Revised language reflects proposal in the paper (¶¶12-14 and Figure 9) that the allocation to government bonds be reduced by 5 percent, that the developed and emerging market bond allocations be combined into a global allocation, and that the allocation to real assets equal 10 percent each to US TIPS, REITs, and infrastructure equities.

<sup>[19]</sup> Revised language reflects proposal in the paper (¶¶18-21 and Figure 9) that the Board determine the asset classes that might be managed actively.

<sup>[20]</sup> Revised language reflects proposal framework in the paper (¶18), under which the Board would determine the key characteristics of the investment approach to be followed for each asset class, including which ones can be invested in private markets.

<sup>[21]</sup> Revised language reflects proposal in the paper (¶18 and Figure 9) that the Managing Director be delegated authority to determine implementation parameters for active in addition to the existing delegation for passive asset classes.

~~categories. The Managing Director, in consultation with the Executive Board, shall determine the investment strategy and investment arrangements for the actively managed portion of the Endowment Subaccount, including the selection criteria and risk parameters for external managers, benchmark indices, the scope and instruments for currency hedging, the phasing of the actively managed portion of the Endowment Subaccount, policy bands and rebalancing procedures, and additional key measures to avoid actual or perceived conflicts of interest.~~<sup>[22]</sup>

32. The asset allocation benchmarks ~~for both the passively and actively managed portions~~<sup>[23]</sup> shall not apply to ~~uninvested residual~~ cash balances, ~~including such balances being held temporarily held uninvested, or~~ in short-term instruments ~~sponsored by~~ of the custodian(s) ~~or an affiliate.~~<sup>[24]</sup>

### **Rebalancing ~~of the Passively Managed Portion~~**<sup>[25]</sup>

33. Based on modalities established by the Managing Director, ~~the passively managed portion assets of the Endowment Subaccount~~<sup>[26]</sup> shall be rebalanced at least annually to minimize deviation from the SAA benchmark specified in paragraph ~~29 28~~ above, or more frequently in the event of significant deviation.

### **Minimum Credit Ratings**

34. ~~With the exception of obligations of the BIS, fixed~~ Except for uninvested cash balances invested in short-term instruments under paragraph 32, fixed-income assets in which the Endowment Subaccount invests are subject to the following minimum credit ~~rating requirements at the time of acquisition~~ ratings by a major credit rating agency at the time of acquisition<sup>[27]</sup> (based on Standard & Poor's long-term rating scale): (a) BBB- for corporate bonds and infrastructure debt, provided that the Managing Director may establish modalities for allowing limited investment in

<sup>[22]</sup> Deleted language reflects proposal in the paper (¶¶17, 18 and Figure 9) that the core-satellite structure of the EA be discontinued.

<sup>[23]</sup> Deleted language reflects proposal in the paper (¶17, 18 and Figure 9) that the core-satellite structure of the EA be discontinued.

<sup>[24]</sup> Technical clarification to reflect prevailing practice more accurately.

<sup>[25]</sup> Deleted language reflects proposal in the paper (¶¶17, 18 and Figure 9) that the core-satellite structure of the EA be discontinued.

<sup>[26]</sup> Deleted language reflects proposal in the paper (¶¶17, 18 and Figure 9) that the core-satellite structure of the EA be discontinued.

<sup>[27]</sup> This non-substantive change was made to promote consistency in terminology used in the IA Rules and TA Guidelines where appropriate.

infrastructure debt that is rated below BBB- at time of acquisition; and (b) BBB+ for remaining assets.

35. In cases where an asset is not directly rated, the Managing Director may determine whether a credit rating may be inferred for such asset in a manner that is consistent with market practice.

## Divestment

36. Any eligible investment that ceases to meet the rating threshold under paragraph ~~3334~~ or otherwise becomes ineligible after acquisition shall be divested within three months, except that corporate bonds and infrastructure debt which fail to meet the rating threshold under paragraph ~~3334~~ after acquisition may be divested or continue to be retained in accordance with modalities established by the Managing Director.

## Limits on Investment Activities

37. The Managing Director shall establish adequate safeguards against short selling and financial leverage.

38. The exchange rate risk for fixed-income securities denominated in (a) developed market currencies vis-à-vis the U.S. dollar shall be hedged ~~for, and (b) emerging market currencies vis-à-vis the passively managed portion of the Endowment Subaccount U.S. dollar may be hedged~~. Currency hedging is not permitted for other passively managed assets ~~of the passively managed portion of the Endowment Subaccount~~.<sup>[28]</sup>

39. ~~For the passively managed portion, derivatives~~ may be used for managing interest rate risk, currency hedging operations required or permitted under paragraph ~~3738~~, or reducing costs in the context of portfolio balancing, benchmark replication, and market access.

~~39. For the actively managed portion, currency hedging and derivatives may be used as determined by the Managing Director subject to adequate risk control parameters.~~<sup>[29]</sup>

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<sup>[28]</sup> Revised language reflects proposal in the paper (T13 and Figure 9) that currency hedging be permitted for fixed-income securities denominated in emerging market currencies.

<sup>[29]</sup> Deleted language reflects proposal in the paper (T17, 18 and Figure 9) that the core-satellite structure of the EA be discontinued.

## Annex III. Guidelines for Investing PRG, PRG-HIPC, and CCR Trust Assets

### GENERAL PROVISIONS

#### Investment Assets

1. These Guidelines establish the investment objectives and policies to guide the investment of resources of the Poverty Reduction and Growth Trust ("PRG Trust"), the Trust for Special Poverty and Growth Operations for the Heavily Indebted Poor Countries and Interim ECF Subsidy Operations ("PRG-HIPC Trust") and the Catastrophe Containment and Relief Trust ("CCR Trust") (each a "Trust," and collectively the "Trusts").
2. The resources of each Trust available for investment and subject to these Guidelines ("Investment Assets") shall consist of resources transferred from the Special Disbursement Account ("SDA") and donor contributions to the respective Trust.

#### Responsibilities of the Managing Director

3. The Managing Director is responsible for implementing the investment policies set out in these Guidelines.
4. In carrying out the Managing Director's responsibilities, the Managing Director shall (a) establish effective decision-making and oversight arrangements; (b) take the necessary measures, including the adoption of policies and procedures, that seek to avoid actual or perceived conflicts of interest; (c) adopt responsible investing principles that incorporate environmental, social, and governance (ESG) considerations into the investment process to support the investment objectives of the Trust Assets and to uphold the Fund's reputation; and (d) establish specific risk control measures and put in place mechanisms to monitor their observance by asset managers.
5. In connection with the adoption of measures under paragraph 4, the Managing Director shall consult with the Executive Board regarding key conflicts of interest policies and arrangements and responsible investment principles and arrangements.
6. The Managing Director shall provide annual reports to the Executive Board on the investment activities of the Trusts. Ad hoc reports shall be prepared as warranted by market or other developments.

### **External Asset Managers**

7. The Investment Assets of the Trusts shall be managed by external managers, except that the Managing Director is authorized to manage: (a) investments in obligations of the Bank for International Settlements (BIS) and central bank deposits; and (b) other Investment Assets of the Trusts on an interim basis following the termination of an external asset manager and pending the transfer of the assets to another external asset manager.

8. The Managing Director shall only select external asset managers of the highest professional standards, and shall take into account their proven skills and track record suitable to achieve the investment objectives and to carry out the investment strategies set out under these Guidelines.

### **Custody Arrangements**

9. The Managing Director shall establish adequate measures for the safekeeping and custody of the Investment Assets of the Trusts.

### **Audit**

10. The Investment Assets of the Trusts shall be audited by the Fund's external auditors and included in the annual financial statements of the Fund.

### **Review of the Guidelines and Conflict of Interest Policies**

11. The Executive Board shall review these Guidelines and the Fund's relevant conflict of interest policies at least every five years.

## **INVESTMENT OF ASSETS OF THE PRG TRUST**

### **Investment Objectives**

12. The Investment Assets of the PRG Trust shall be invested taking into account the purposes of these assets (a) to generate income to support the self-sustaining operations of the PRG Trust, (b) to provide security to lenders to the PRG Trust, and (c) to provide adequate liquidity for the PRG Trust's operational needs.

13. The return target of the PRG Trust's investment is to generate a margin of 90 basis points above the three-month SDR rate, over a long-term investment horizon of at least 10 years.

### **Target Asset Allocation**

14. The Investment Assets of the PRG Trust shall be invested according to the following allocation targets as a percent of the Investment Assets of the PRG Trust: (a) 60 percent in liquidity and short duration fixed-income components, with the specific allocation between these two components to be established by the Managing Director, (b) 15 percent in a component of corporate bonds, (c) 5 percent in a component of emerging market government bonds, and (d) 20 percent in a component of global equities.

### **Eligible Investments**

15. The liquidity component shall be limited to BIS deposits and central bank deposits, in each case with a maximum maturity of up to one year and denominated in SDR or currencies included in the SDR basket.

16. (a) The following guidelines apply to the short duration fixed-income component:
- i. The short duration fixed-income component shall consist of two tranches, a shorter-duration Tranche 1 and a longer-duration Tranche 2, and shall have a maximum average duration of 3 years.
  - ii. Tranche 1 assets shall be managed actively. Eligible asset classes for Tranche 1 are Group 1 and Group 2 asset classes as defined in paragraph 16(b) below.
  - iii. Tranche 2 assets shall be managed according to a buy-and-hold investment approach. Eligible asset classes for Tranche 2 are Group 1 asset classes as defined in paragraph 16(b) below.
  - iv. Asset transfers between Tranche 1 and Tranche 2 and the allocation to Tranche 1 and Tranche 2 of future inflows to, and outflows from, the short duration fixed-income component shall be determined by the Managing Director.

- (b) The following guidelines shall apply to Group 1 and Group 2 asset classes:
- i. "Group 1 asset classes" shall be limited to:
- A. debt obligations issued by national governments of members or their central banks;
  - B. debt obligations issued by national agencies of members;
  - C. debt obligations issued by supranational institutions; and
  - D. obligations issued by the BIS, including without limitation deposits with the BIS and MTIs;
- all of which shall be denominated in SDR or the currencies included in the SDR basket.
- (ii) "Group 2 asset classes" shall be limited to:
- A. debt obligations issued by national governments of members or their central banks denominated in non-SDR currencies selected by the Managing Director or, upon the authorization by the Managing Director, by external managers, provided that any currency selection shall be based on ex-ante criteria determined by the Managing Director;
  - B. debt obligations denominated in SDR or the currencies included in the SDR basket, comprising: (I) securities issued by subnational governments; (II) mortgage-backed and other asset-backed securities; (III) covered bonds; and (IV) short-dated unsecured corporate bonds; and
  - C. cash-equivalent investments with maturities of one year or less, that are denominated in SDR or the currencies included in the SDR basket.
- (c) Up to the maximum 40 percent of the total value of the short duration fixed-income component may be invested in Group 2 asset classes, and the breach of this limit shall

require prompt action to bring the short duration fixed-income component back within the established limit.

17. The Managing Director shall establish the parameters for determining the specific assets eligible for the corporate bond, emerging market government bond and global equity components, and for duration and currency requirements for the corporate bond and emerging market government bond components. On an exceptional basis, the Managing Director may permit the inclusion of debt obligations issued by national governments of members or their central banks in the corporate bond component.

18. In addition to investing in the assets as set out above, residual cash balances may be held temporarily uninvested, or in the short-term instruments sponsored by the custodian(s) or an affiliate.

### **Investment Management**

19. The liquidity component shall be managed to meet the operational needs of the PRG Trust.

20. The short duration fixed-income component shall be managed in accordance with paragraph 16 above.

21. The components of corporate bonds, emerging market government bonds, and global equities shall be managed passively, with the exception of emerging markets equities which may be managed actively.

### **Target Asset Allocation Rebalancing**

22. Based on modalities established by the Managing Director, the allocation of the Investment Assets of the PRG Trust shall be rebalanced at least annually to minimize deviation from the allocation targets under paragraph 14 above or more frequently in the event of significant deviation.

### **Minimum Credit Ratings**

23. Except for obligations of the BIS, central bank deposits, uninvested cash balances and equities, all assets in which the PRG Trust invests must have a credit rating equivalent to at least BBB- for corporate bonds and BBB+ for all other assets (based on Standard & Poor's long-term

rating scale) by a major credit rating agency at the time of acquisition. The Managing Director may establish higher credit ratings for eligible individual asset classes.

24. In cases where an asset is not directly rated, the Managing Director may determine whether a credit rating may be inferred for such asset in a manner that is consistent with market practice.

### **Divestment**

25. Any eligible investment that ceases to meet the rating threshold under paragraph 23 or otherwise becomes ineligible after acquisition shall be divested within three months, except that corporate bonds which fail to meet the rating threshold under paragraph 23 after acquisition may be divested or continue to be retained in accordance with modalities established by the Managing Director.

### **Limits on Investment Activities**

26. The Managing Director shall establish adequate safeguards against short selling and financial leverage.

27. Derivatives may be used for managing interest rate risk, currency hedging, or reducing costs in the context of portfolio balancing, benchmark replication and market access. The currency composition of the liquidity, short duration fixed-income, and corporate bond components shall be aligned with, or hedged to, the SDR basket composition.

## **OTHER TRUST ASSETS**

### **Investment Objectives**

28. The Investment Assets of the PRG-HIPC and CCR Trusts shall be invested to enhance returns subject to the liquidity requirements of each Trust while limiting the risk of impairment of capital over an investment horizon of no more than three years.

## Eligible Investments

29. The Investment Assets of each of the PRG-HIPC and CCR Trusts shall be invested in a liquidity component and an investment component, with the specific allocation between the two components determined by the Managing Director.
30. The liquidity component shall be limited to BIS deposits and central bank deposits, in each case with a maximum maturity of up to one year and denominated in SDR or currencies included in the SDR basket.
31. The investment component shall be limited to marketable obligations issued by a member or by a national official financial institution of a member that are denominated in SDR; marketable obligations issued by a member or by a national official financial institution of a member whose currency is in the SDR basket and that are denominated in the currency of that member; marketable obligations issued by international financial organizations and denominated in SDR or in a currency in the SDR basket; and deposits with a commercial bank, a national financial institution of a member, or an international financial institution that are denominated in SDR or in a currency in the SDR basket.
32. The investment component shall have a maximum average duration of three years.

## Investment Management

33. The liquidity component shall be managed to meet the operational needs of the respective trust.
34. The investment component shall be managed actively except for investments in obligations of the BIS and central bank deposits managed by the Managing Director.

## Currency Composition Rebalancing

35. The currency composition of the Investment Assets of the PRG-HIPC and CCR Trusts shall be rebalanced periodically to the SDR basket composition.

### **Minimum Credit Ratings**

36. Except for obligations of the BIS, central bank deposits and uninvested cash balances, all assets in which the PRG-HIPC Trust and CCR Trust invest must have a credit rating equivalent to at least A (based on Standard & Poor's long-term rating scale) by a major credit rating agency at the time of acquisition.

37. In cases where an asset is not directly rated, the Managing Director may determine whether a credit rating may be inferred for such asset in a manner that is consistent with market practice.

### **Divestment**

38. Any eligible investment that ceases to meet the rating threshold in paragraph 36 or otherwise becomes ineligible after acquisition shall be divested within three months.

### **Limits on Investment Activities**

39. The Managing Director shall establish adequate safeguards against short selling and financial leverage.

40. Derivatives shall be prohibited except for forwards entered into for purposes of currency hedging with eligible issuers under paragraph 31.

### **Use of Currencies**

41. Investment which does not involve an exchange of currency shall be made only after consultation with the member whose currency is to be used, or, when an exchange of currencies is involved, with the consent of the issuers of such currencies.

## Annex IV. Redline of Guidelines for Investing PRG, PRG-HIPC, and CCR Trust Assets

### GENERAL PROVISIONS

#### Investment Assets

1. These Guidelines establish the investment objectives and policies to guide the investment of resources of the Poverty Reduction and Growth Trust ("PRG Trust"), the Trust for Special Poverty and Growth Operations for the Heavily Indebted Poor Countries and Interim ECF Subsidy Operations ("PRG-HIPC Trust") and the Catastrophe Containment and Relief Trust ("CCR Trust") (each a "Trust," and collectively the "Trusts").
2. The resources of each Trust available for investment and subject to these Guidelines ("Investment Assets") shall consist of resources transferred from the Special Disbursement Account ("SDA") and donor contributions to the respective Trust.

#### Responsibilities of the Managing Director

3. The Managing Director is responsible for implementing the investment policies set out in these Guidelines.
4. In carrying out the Managing Director's responsibilities, the Managing Director shall (a) establish effective decision-making and oversight arrangements; (b) take the necessary measures, including the adoption of policies and procedures, that seek to avoid actual or perceived conflicts of interest; (c) adopt responsible investing principles that incorporate environmental, social, and governance (ESG) considerations into the investment process to support the investment objectives of the Trust Assets and to uphold the Fund's reputation;<sup>[1]</sup> and (d) establish specific risk control measures and put in place mechanisms to monitor their observance by asset managers.

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<sup>[1]</sup> Inserted language reflects proposal in the paper (11/46-48) that the Board delegate to the Managing Director the authority to adopt responsible investment principles and arrangements.

5. In connection with the adoption of measures under paragraph 4(~~b~~), the Managing Director shall consult with the Executive Board regarding key conflicts of interest policies and arrangements and responsible investment principles and arrangements.<sup>[2]</sup>

6. The Managing Director shall provide annual reports to the Executive Board on the investment activities of the Trusts. Ad hoc reports shall be prepared as warranted by market or other developments.

### **External Asset Managers**

7. The Investment Assets of the Trusts shall be managed by external managers, except that the Managing Director is authorized to manage: (a) investments in obligations of the Bank for International Settlements (BIS) and central bank deposits; and (b) other Investment Assets of the Trusts on an interim basis following the termination of an external asset manager and pending the transfer of the assets to another external asset manager.

8. The Managing Director shall only select external asset managers of the highest professional standards, and shall take into account their proven skills and track record suitable to achieve the investment objectives and to carry out the investment strategies set out under these Guidelines.

### **Custody Arrangements**

9. The Managing Director shall establish adequate measures for the safekeeping and custody of the Investment Assets of the Trusts.

### **Audit**

10. The Investment Assets of the Trusts shall be audited by the Fund's external auditors and included in the annual financial statements of the Fund.

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<sup>[2]</sup> Inserted language reflects proposal in the paper (11/46-48) that the Board delegate to the Managing Director the authority to adopt responsible investment principles and arrangements.

## Review of the Guidelines and Conflict of Interest Policies

11. The Executive Board shall review these Guidelines and the Fund's relevant conflict of interest policies at least every five years.

## INVESTMENT OF ASSETS OF THE PRG TRUST

### Investment Objectives

12. The Investment Assets of the PRG Trust shall be invested taking into account the purposes of these assets (a) to generate income to support the self-sustaining operations of the PRG Trust, (b) to provide security to lenders to the PRG Trust, and (c) to provide adequate liquidity for the PRG Trust's operational needs.

13. The return target of the PRG Trust's investment is to generate a margin of 90 basis points above the ~~six~~<sup>three</sup><sup>[3]</sup>-month SDR rate, over a long-term investment horizon of at least 10 years.

### Target Asset Allocation ~~and Eligible Investments~~<sup>[4]</sup>

14. The Investment Assets of the PRG Trust shall be invested according to the following allocation targets as a percent of the Investment Assets of the PRG Trust: (a) ~~45~~<sup>60</sup> percent in liquidity and short duration fixed-income components, with the specific allocation between these two components to be established by the Managing Director, (b) ~~30~~<sup>15</sup> percent in a component of corporate bonds, (c) 5 percent in a component of emerging market government bonds, and (d) 20 percent in a component of ~~publicly listed~~ global<sup>[5]</sup> equities.

### Eligible Investments

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<sup>[3]</sup> Revised language reflects proposal in the paper (Figure 17 and footnote 27) that the investment objectives be updated from the 6-month to the standard 3-month rate to reflect the uniform remuneration rate recently agreed by lenders.

<sup>[4]</sup> Change in title reflects the update to the SDFI section (Figure 17).

<sup>[5]</sup> Revised language is to align the PRGT's equity component with the EA's equity allocation, including to reflect the clarification about public market investments in the paper (¶¶ 18, 41 and footnotes 13, 31).

15. ~~(a)~~ The liquidity component shall be limited to BIS deposits and central bank deposits, in each case with a maximum maturity of up to one year and denominated in SDR or currencies included in the SDR basket.

~~(b) — The short duration fixed-income component shall have a maximum average duration of three years and be limited to the following:<sup>[6]</sup>~~

~~i. debt obligations issued by national governments of members or their central banks denominated in SDR, currencies included in the SDR basket or non-SDR currencies selected pursuant to ex ante criteria determined by the Managing Director;~~

~~ii. debt obligations denominated in SDR or currencies included in the SDR basket issued by national agencies of the members whose currencies are in the SDR basket;~~

~~iii. debt obligations denominated in SDR or currencies included in the SDR basket issued by international financial institutions;~~

~~iv. obligations of the BIS, including without limitation deposits with the BIS and Medium-Term Instruments, denominated in SDR or currencies included in the SDR basket; and~~

~~v. cash-equivalent investments with maturities of one year or less, that are denominated in SDR or currencies included in the SDR basket.~~

16. (a) The following guidelines apply to the short duration fixed-income component:<sup>[7]</sup>

- i. The short duration fixed-income component shall consist of two tranches, a shorter-duration Tranche 1 and a longer-duration Tranche 2, and shall have a maximum average duration of 3 years.

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<sup>[6]</sup> Deleted language reflects proposal in the paper (¶42 and Figure 17) that a short duration fixed-income strategy consistent with the Fixed-Income Subaccount section of the Rules (¶¶17-20) be added as a stand-alone investment option for PRGT accounts.

<sup>[7]</sup> Inserted language throughout this ¶16 reflects proposal in the paper (¶42 and Figure 17) that a short duration fixed-income strategy consistent with the Fixed-Income Subaccount section of the Rules (¶¶17-20) be added as a stand-alone investment option for PRGT accounts.

- ii. Tranche 1 assets shall be managed actively. Eligible asset classes for Tranche 1 are Group 1 and Group 2 asset classes as defined in paragraph 16(b) below.
  - iii. Tranche 2 assets shall be managed according to a buy-and-hold investment approach. Eligible asset classes for Tranche 2 are Group 1 asset classes as defined in paragraph 16(b) below.
  - iv. Asset transfers between Tranche 1 and Tranche 2 and the allocation to Tranche 1 and Tranche 2 of future inflows to, and outflows from, the short duration fixed-income component shall be determined by the Managing Director.
- (b) The following guidelines shall apply to Group 1 and Group 2 asset classes:
- i. “Group 1 asset classes” shall be limited to:
    - A. debt obligations issued by national governments of members or their central banks;
    - B. debt obligations issued by national agencies of members;
    - C. debt obligations issued by supranational institutions; and
    - D. obligations issued by the BIS, including without limitation deposits with the BIS and MTIs;

all of which shall be denominated in SDR or the currencies included in the SDR basket.
  - (ii) “Group 2 asset classes” shall be limited to:
    - A. debt obligations issued by national governments of members or their central banks denominated in non-SDR currencies selected by the Managing Director or, upon the authorization by the Managing Director, by external managers, provided that any currency selection shall be based on ex-ante criteria determined by the Managing Director;

- B. debt obligations denominated in SDR or the currencies included in the SDR basket, comprising: (I) securities issued by subnational governments; (II) mortgage-backed and other asset-backed securities; (III) covered bonds; and (IV) short-dated unsecured corporate bonds; and
  - C. cash-equivalent investments with maturities of one year or less, that are denominated in SDR or the currencies included in the SDR basket.
- (c) Up to the maximum 40 percent of the total value of the short duration fixed-income component may be invested in Group 2 asset classes, and the breach of this limit shall require prompt action to bring the short duration fixed-income component back within the established limit.

17. The Managing Director shall establish the parameters for determining the specific assets eligible for the corporate bond, emerging market government bond and ~~publicly listed global~~<sup>[8]</sup> equity components, and for duration and currency requirements for the corporate bond and emerging market government bond components. On an exceptional basis, the Managing Director may permit the inclusion of debt obligations issued by national governments of members or their central banks in the corporate bond component.

18. In addition to investing in ~~eligible~~<sup>[9]</sup> assets as set out above, ~~uninvested residual~~ cash balances may be held temporarily ~~uninvested, or~~ in the short-term instruments ~~of sponsored by~~ the custodian(s) ~~or an affiliate~~.<sup>[9]</sup>

## Investment Management

19. The liquidity component shall be managed to meet the operational needs of the PRG Trust.

20. The short duration fixed-income component shall be managed ~~actively, except for obligations of the BIS and central bank deposits managed by the Managing Director in accordance with paragraph 16 above~~.<sup>[10]</sup>

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<sup>[8]</sup> Revised language is to align with the EA as described in the paper (¶¶18, 41 and footnotes 13, 31).

<sup>[9]</sup> Technical clarification to reflect prevailing practice more accurately.

<sup>[10]</sup> Revised language reflects proposal in the paper (¶140 and Figure 17) that the short duration fixed-income component of the PRG Trust mirror that of the Fixed Income Subaccount.

21. The components of corporate bonds, emerging market government bonds, and global equities shall be managed passively, with the exception of emerging markets equities which may be managed actively.<sup>[11]</sup>

### Target Asset Allocation Rebalancing

22. ~~Based on modalities established by the Managing Director, the~~ allocation of the Investment Assets of the PRG Trust shall be rebalanced at least annually to minimize deviation from the allocation targets under paragraph 14 above ~~at least annually after the phase-in, to the target asset allocation set out in paragraph 25 below has been completed. The Managing Director shall establish maximum deviation bands around these allocation targets, and corresponding modalities for rebalancing or more frequently in the event of significant deviation.~~<sup>[12]</sup>

### Minimum Credit Ratings

23. Except for obligations of the BIS, central bank deposits, uninvested cash balances and equities, all assets in which the PRG Trust invests must have a credit rating equivalent to at least BBB- for corporate bonds and BBB+ for all other assets (based on Standard & Poor's long-term rating scale) by a major credit rating agency at the time of acquisition. The Managing Director may establish higher credit ratings for eligible individual asset classes.<sup>[13]</sup>

24. In cases where an asset is not directly rated, the Managing Director may determine whether a credit rating may be inferred for such asset in a manner that is consistent with market practice.

### Divestment

25. Any eligible investment that ceases to meet the rating threshold under paragraph 2023 or otherwise becomes ineligible after acquisition shall be divested within three months, except that corporate bonds which fail to meet the rating threshold under paragraph 2023 after acquisition may

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<sup>[11]</sup> Revised language reflects proposal in the paper (¶¶18-21 and Figure 17) that the Board determine the asset classes that might be managed actively.

<sup>[12]</sup> This change was made to align PRGT's rebalancing policy and practices with the EA's (¶41).

<sup>[13]</sup> Inserted language reflects proposal in the paper (¶40 and Figure 17) that the short duration fixed-income component of the PRG Trust mirror that of the Fixed-Income Subaccount.

be divested or continue to be retained in accordance with modalities established by the Managing Director.

### **Limits on Investment Activities**

26. The Managing Director shall establish adequate safeguards against short selling and financial leverage.

27. Derivatives may be used for managing interest rate risk, currency hedging, or reducing costs in the context of portfolio balancing, benchmark replication and market access. The currency composition of the liquidity, short duration fixed-income, and corporate bond components shall be aligned with, or hedged to, the SDR basket composition.

### **~~Phase-in to Target Asset Allocation~~**

~~25. The portfolio shall be phased in to the target asset allocation under paragraph 14 above over a period of three years, or up to four years in exceptional circumstances.~~<sup>[14]</sup>

## **OTHER TRUST ASSETS**

### **Investment Objectives**

28. The Investment Assets of the PRG-HIPC and CCR Trusts shall be invested to enhance returns subject to the liquidity requirements of each Trust while limiting the risk of impairment of capital over an investment horizon of no more than three years.

### **Eligible Investments**

29. The Investment Assets of each of the PRG-HIPC and CCR Trusts shall be invested in a liquidity component and an investment component, with the specific allocation between the two components determined by the Managing Director.

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<sup>[14]</sup> Deleted language is no longer relevant given completion of the phase-in discussed in the paper ¶36.

30. The liquidity component shall be limited to BIS deposits and central bank deposits, in each case with a maximum maturity of up to one year and denominated in SDR or currencies included in the SDR basket.
31. The investment component shall be limited to marketable obligations issued by a member or by a national official financial institution of a member that are denominated in SDR; marketable obligations issued by a member or by a national official financial institution of a member whose currency is in the SDR basket and that are denominated in the currency of that member; marketable obligations issued by international financial organizations and denominated in SDR or in a currency in the SDR basket; and deposits with a commercial bank, a national financial institution of a member, or an international financial institution that are denominated in SDR or in a currency in the SDR basket.
32. The investment component shall have a maximum average duration of three years.

### **Investment Management**

33. The liquidity component shall be managed to meet the operational needs of the respective trust.
34. The investment component shall be managed actively except for investments in obligations of the BIS and central bank deposits managed by the Managing Director.

### **Currency Composition Rebalancing**

35. The currency composition of the Investment Assets of the PRG-HIPC and CCR Trusts shall be rebalanced periodically to the SDR basket composition.

### **Minimum Credit Ratings**

36. Except for obligations of the BIS, central bank deposits and uninvested cash balances, all assets in which the PRG-HIPC Trust and CCR Trust invest must have a credit rating equivalent to at least A (based on Standard & Poor's long-term rating scale) by a major credit rating agency at the time of acquisition.

37. In cases where an asset is not directly rated, the Managing Director may determine whether a credit rating may be inferred for such asset in a manner that is consistent with market practice.

### **Divestment**

38. Any eligible investment that ceases to meet the rating threshold in paragraph [3436](#) or otherwise becomes ineligible after acquisition shall be divested within three months.

### **Limits on Investment Activities**

39. The Managing Director shall establish adequate safeguards against short selling and financial leverage.

40. Derivatives shall be prohibited except for forwards entered into for purposes of currency hedging with eligible issuers under paragraph [2931](#).

### **Use of Currencies**

41. Investment which does not involve an exchange of currency shall be made only after consultation with the member whose currency is to be used, or, when an exchange of currencies is involved, with the consent of the issuers of such currencies.

## Annex V. Performance of IA and TA Portfolios (as of 9/30/2021)

ENDOWMENT SUBACCOUNT (EA)							
	FY2022 to 9/30/21	FY2021	FY2020	FY2019	FY2018	Strategy ITD	Strategy Inception Date
<i>Figures expressed in USD 1/</i>							
<b>Total Endowment (EA)</b>	<b>0.93</b>	<b>19.76</b>	<b>0.61</b>	<b>4.72</b>	<b>5.42</b>	<b>5.89</b>	<b>Mar-14</b>
<b>Endowment - Passive</b>	<b>0.94</b>	<b>19.86</b>	<b>0.52</b>	<b>4.66</b>	<b>5.44</b>	<b>5.90</b>	<b>Mar-14</b>
Fixed Income	1.04	3.29	6.49	4.45	1.29	3.67	Mar-14
DM Sovereigns	0.71	(3.30)	10.73	5.47	(0.01)	3.17	Mar-14
DM Corporates	0.60	3.81	5.04	5.61	1.09	3.75	Mar-14
EM Bonds	(3.17)	7.74	2.90	1.58	5.86	1.80	Mar-14
Inflation-Linked Bonds	2.68	6.78	5.69	3.70	0.44	4.75	Mar-14
Infrastructure Debt	0.22	--	--	--	--	0.27	Oct-20
Equities	0.80	47.75	(8.32)	5.16	13.07	9.30	Mar-14
DM Equities	2.66	48.30	(4.83)	6.24	13.83	10.49	Mar-14
EM Equities	(4.69)	51.23	(12.58)	(5.62)	21.02	6.25	Mar-14
REITs	2.56	37.06	(17.71)	13.82	1.43	7.02	Mar-14
<b>Endowment - Active</b>	<b>0.74</b>	<b>17.57</b>	<b>2.55</b>	<b>5.90</b>	<b>4.36</b>	<b>6.15</b>	<b>Aug-16</b>
<i>GED + 3 percent 2/</i>	<b>4.00</b>	<i>5.40</i>	<i>5.60</i>	<i>5.30</i>	<i>5.90</i>	<b>5.52</b>	<i>Mar-14</i>
FIXED-INCOME SUBACCOUNT (FI)							
	FY2022 to 9/30/21	FY2021	FY2020	FY2019	FY2018	Strategy ITD	Strategy Inception Date
<i>Figures expressed in SDR 1/</i>							
<b>Fixed-Income Subaccount (FI)</b>	<b>0.25</b>	<b>0.52</b>	<b>1.93</b>	<b>1.56</b>	<b>0.60</b>	<b>0.98</b>	<b>Aug-16</b>
<b>Tranche 1</b>	<b>0.33</b>	<b>0.86</b>	<b>1.79</b>	<b>1.47</b>	<b>0.74</b>	<b>1.02</b>	<b>Aug-16</b>
<b>Tranche 2</b>	<b>0.12</b>	<b>(0.13)</b>	<b>2.23</b>	<b>1.65</b>	<b>0.46</b>	<b>0.97</b>	<b>Mar-17</b>
Tranche 2 Buy & Hold	0.13	(0.09)	3.00	2.18	(0.11)	1.16	Mar-17
Legacy portfolio	0.05	(0.08)	1.23	1.37	0.59	--	--
<i>3m SDR rate 3/</i>	<i>0.02</i>	<i>0.08</i>	<i>0.77</i>	<i>1.04</i>	<i>0.68</i>	<i>0.53</i>	<i>Aug-16</i>
<i>ML 0-3 Year Index 3/</i>	<i>0.11</i>	<i>(0.12)</i>	<i>2.31</i>	<i>1.54</i>	<i>0.06</i>	<i>0.74</i>	<i>Aug-16</i>
<i>ML 0-5 Year Index 3/</i>	<i>0.10</i>	<i>(0.34)</i>	<i>3.22</i>	<i>1.97</i>	<i>(0.19)</i>	<i>1.09</i>	<i>Mar-17</i>
TRUST ASSETS (TA)							
	FY2022 to 9/30/21	FY2021	FY2020	FY2019	FY2018	Strategy ITD	Strategy Inception Date
<i>Figures expressed in SDR 1/</i>							
<b>Total Trust Assets (TA)</b>	<b>0.67</b>	<b>7.04</b>	<b>1.27</b>	<b>2.31</b>	<b>0.32</b>	<b>2.92</b>	<b>Dec-17</b>
<b>PRGT Assets - Pooled</b>	<b>0.72</b>	<b>7.64</b>	<b>1.27</b>	<b>2.39</b>	<b>--</b>	<b>3.11</b>	<b>Dec-17</b>
Liquidity component (BIS Deposits)	0.02	0.00	0.58	0.69	--	0.40	Dec-17
Short Duration Fixed Income	0.07	0.01	2.28	1.73	--	1.06	Dec-17
DM Corporates	0.90	3.34	3.81	--	--	4.18	Dec-18
EM Bonds	(1.35)	2.35	4.48	--	--	2.97	Oct-18
Equities	2.30	41.49	(5.48)	--	--	14.50	Oct-18
DM Equities	4.47	40.78	(2.99)	--	--	15.62	Oct-18
EM Equities	(3.00)	43.00	(11.43)	--	--	11.58	Oct-18
BIS Deposits (Non-Pooled PRGT)	0.03	0.22	0.97	0.99	--	0.65	--
<b>Other Trust Assets</b>	<b>(0.01)</b>	<b>(0.08)</b>	<b>1.52</b>	<b>1.46</b>	<b>--</b>	<b>0.77</b>	<b>Dec-17</b>
<i>6-Month SDR Rate 4/</i>	<i>0.02</i>	<i>0.10</i>	<i>0.77</i>	<i>1.15</i>	<i>0.63</i>	<i>0.63</i>	<i>Dec-17</i>
<i>6-Month SDR + 90 bp 4/</i>	<i>0.40</i>	<i>1.00</i>	<i>1.67</i>	<i>2.05</i>	<i>1.53</i>	<i>1.53</i>	<i>Dec-17</i>
<i>ML 0-3 Year Index 4/</i>	<i>0.11</i>	<i>(0.12)</i>	<i>2.31</i>	<i>1.54</i>	<i>0.06</i>	<i>0.74</i>	<i>Aug-16</i>

Sources: State Street and staff calculations; OBP for GED.

1/ Portfolio returns are in percent (unless otherwise noted) and net of fees. Fees include management and custody fees in addition to other fees, such as index fees. Returns over one year are annualized. Figures for partial periods are not presented.

2/ The Global External Deflator (GED) plus 3 percent is the long-term return objective of the EA. GED as published by OBP through end FY2021, and realized U.S. CPI for FY2022 to end-September 2021.

3/ FI Benchmarks: ML 0-3 y and 3-month SDRi are the benchmarks for FI-Tranche 1 portfolio. ML 0-5 is the benchmark for FI-Tranche 2 buy and hold portfolio. The 3-month SDRi is also the opportunity cost for the FI.

4/ PRGT benchmarks: The 6-month SDR rate +90 bp is the long-term objective of the PRGT. ML 0-3 is the benchmark for the PRGT Short Duration Fixed Income portfolio.

## Annex VI. Scenario Analysis and Portfolio Simulations for IA and TA Portfolios

### Background

**1. Staff’s analysis of forward-looking return and risk for IA and TA portfolios is based on a stochastic simulation model and market assumptions constructed from a consistent set of economic scenarios.**<sup>1</sup> Long-term capital market assumptions use a factor-based building block approach. This approach simulates relevant economic and financial market variables and their linkage to asset behavior on a consistent basis over short, medium, and long-term investment horizons. Current market conditions, medium-term business cycle indicators, as well as long-term trend factors are integrated into the simulations to approximate real world scenarios. The resulting return distribution for different assets and portfolios over various timeframes forms the basis of staff’s projections for the IA and TA portfolios. Model portfolios are used to proxy the current and alternative portfolios including the impact of potential strategy refinements. The risk and return is assessed according to the relevant investment horizon for each portfolio. In addition, different stress scenarios for each portfolio are also analyzed to assess downside risk. These scenarios include for example, inflation risk, rising interest rates, or widening credit spreads.

**2. The current baseline assumptions in general reflect lower returns for all asset classes going forward given the historically low level of yields in developed markets and the current equity market valuations** (Figure VI.1). They assume a gradual interest rate normalization over the long term to lower levels than historical averages, and compressed equity returns. Under these assumptions, the historically low developed market bond yields and high equity market valuations will limit future prospective returns. Over the short to medium term, the global economy and financial markets face significant uncertainty as the extraordinary fiscal and monetary support measures employed following the pandemic outbreak are phased out. In addition, implications on asset returns from secular trends such as increasing debt levels, aging demographics, and climate change increase the uncertainty around long-term expectations.<sup>2</sup> Overall, fixed-income assets are expected to offer low returns while real assets and equities are expected to generate more attractive returns but with higher return variability (Figure VI.1). As expected, there is greater uncertainty in the short- to medium-term return projections, in part due to potential impact of policy normalization and inflationary pressures; over a long-term investment horizon, the expected return distribution is narrower (partly due to the compounding effect over long-term periods).

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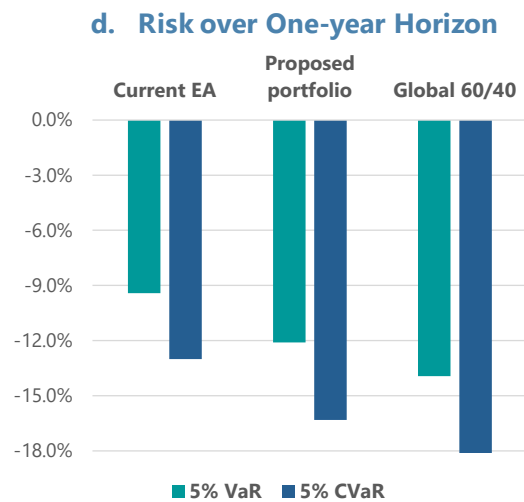
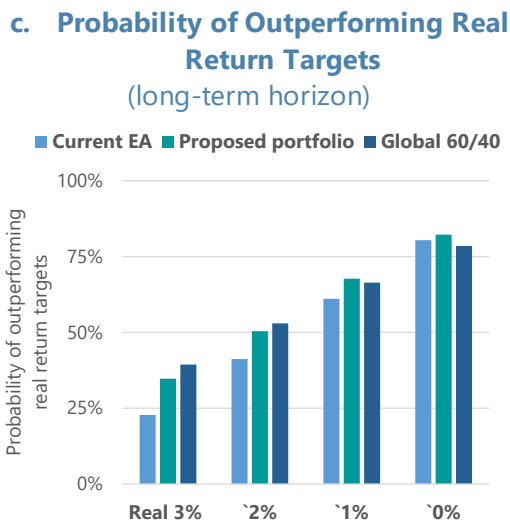
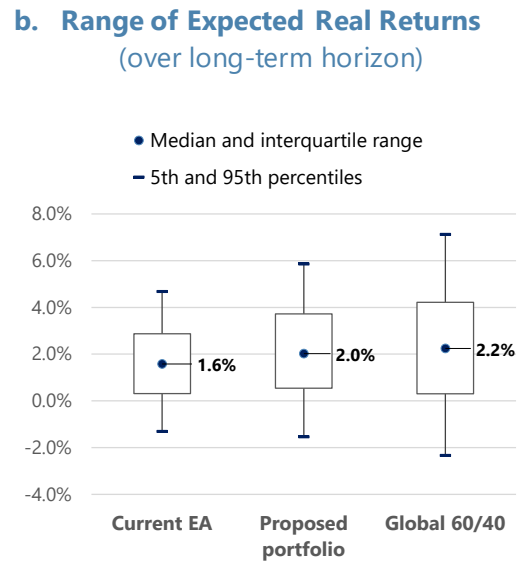
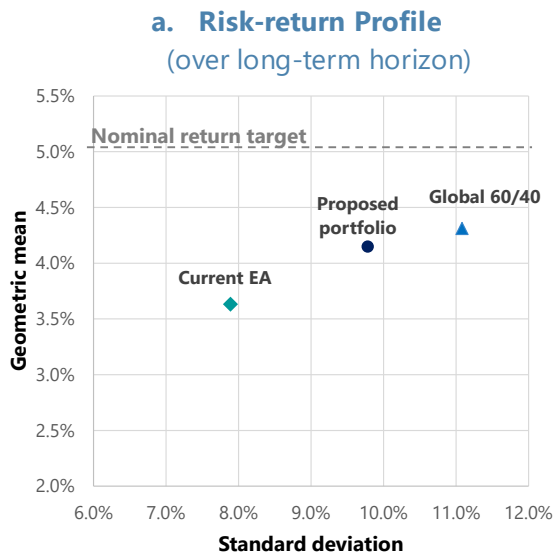
<sup>1</sup> Staff analysis uses market scenario assumptions and a modeling tool developed by Ortec Finance, which specializes in asset-liability modeling for pension funds globally.

<sup>2</sup> The uncertainty is incorporated through a distribution around the long-term average assumptions for relevant factors.



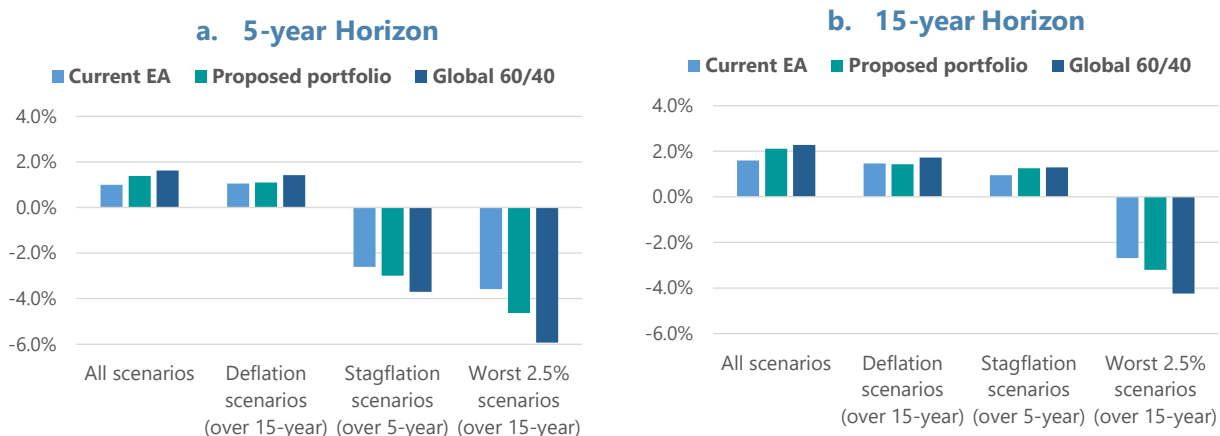
returns in stagflation scenarios or the worst-case scenarios compared with a global 60/40 portfolio (Figure VI.3a).

**Figure VI.2. Comparisons between Current EA, Proposed Portfolio, and Global 60/40 Portfolio**



Sources: ORTEC and staff analysis, end-September 2021.

Figure VI.3. Average Annualized Real Returns Under Stress Scenarios



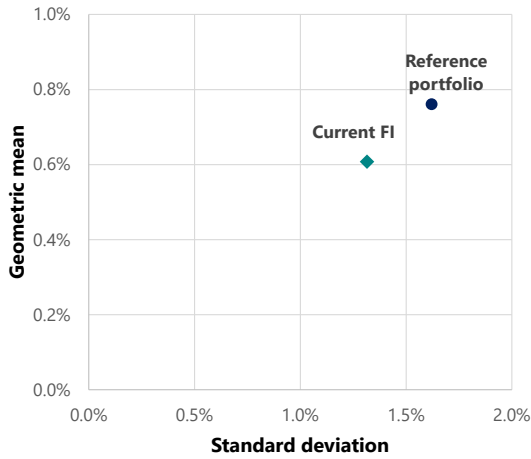
Sources: ORTEC and staff analysis, end-September 2021. Each stress case captures approximately 2.5 percent of the overall simulated paths.

## B. FI Subaccount

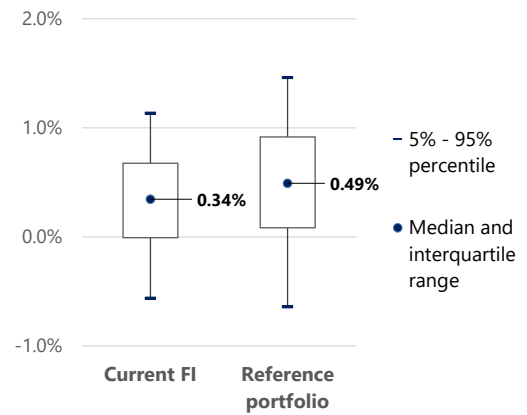
**5. The current FI strategy is expected to remain resilient across a broad range of market conditions and the proposed refinements increase the expected return potential without materially increasing the FI's risk profile** (Figure VI.4a). The proposed refinements—modeled in the reference portfolio through slightly higher duration and credit risk—would help increase the chance of achieving a 50 bp margin over the SDR interest rate (Figure VI.4c). While the expected return distribution is slightly wider, the range of expected returns shifts higher, e.g., at the 25-75 percent confidence level (Figure VI.4b). The short-term risk profile of the portfolio is expected to increase slightly to help improve the probability of achieving a given margin over the SDRi (Figure VI.4d). Similar to the scenario filtering approach used for the EA, several stress scenarios relevant for the FI strategy are also assessed. Under all of these stress scenarios, the proposed reference portfolio is expected to perform better than the current portfolio. The potential negative impact on the FI's return margin above the SDRi in a case of sharply rising interest rates is illustrated in the *"highest yields"* scenarios, corresponding to the simulated paths with the top 10 percent SDR yield levels at the end of the 3-year horizon (Figure VI.5a). Widening spreads could also result in lower expected return margin initially as shown in the *"widest spreads"* scenarios. However, the portfolio would benefit from higher yields and spread levels in subsequent periods (Figure VI.5b). The expected return margin under the stress scenarios corresponding to the lowest 10 percent margins over a 3-year horizon would be positive when measured over 5 years under this assumption, further demonstrating the resilience of the portfolio over time.

**Figure VI.4. Current FI and Reference Portfolio**

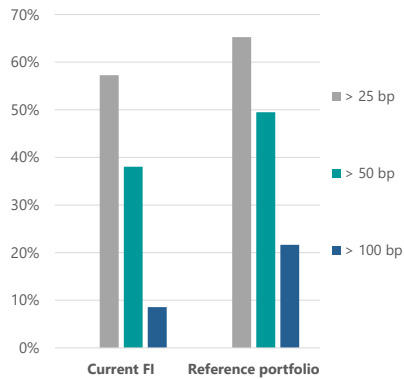
**a. Risk-return Profile**  
(over 3-year horizon)



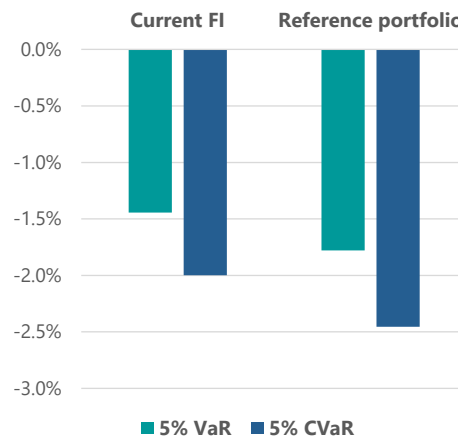
**b. Range of Expected Margin over SDR Interest Rate**  
(over 3-year horizon)



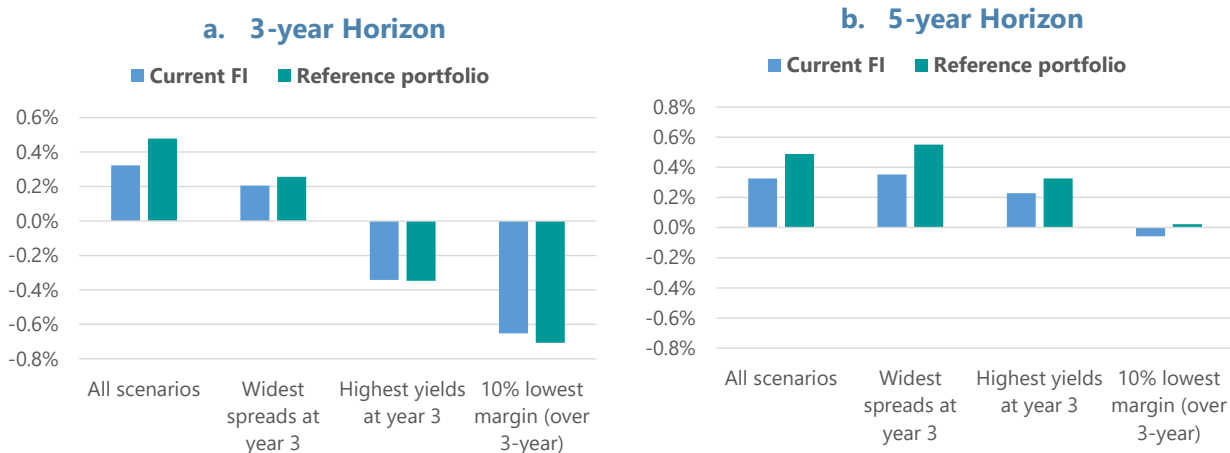
**c. Probability of Achieving Return Margins**  
(3-year horizon)



**d. Risk over One-year Horizon**



Sources: ORTEC and staff analysis, end-September 2021. Current FI proxy has an aggregate duration of 1.9 years and Group 2 assets of 23 percent. The reference portfolio has an aggregate duration of 2.3 years and Group 2 assets of 33 percent (including around 7 percent BBB-rated securities).

**Figure VI.5. Average Annual Return Margins over SDR Interest Rate Under Stress Scenarios**

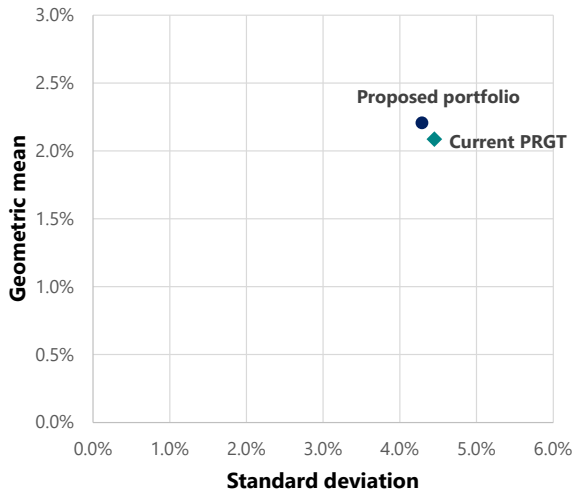
Sources: ORTEC and staff analysis, end-September 2021. Each stress case captures 10 percent of the overall simulated paths. In the "widest spreads" case, U.S. 5-year corporate spreads are on average about 260 bp wider, while in the "highest yields" case SDR 5-year yields are on average about 120 bp higher than the respective averages under "all scenarios" at the end of the 3-year horizon.

## C. PRGT Portfolio

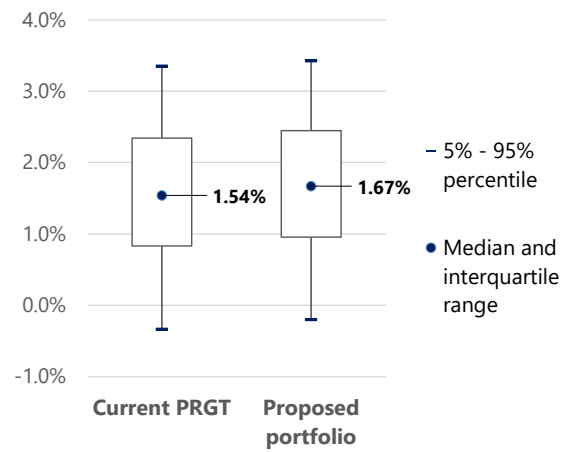
**6. The PRGT strategy has a high probability of achieving the 90 bp margin over SDRi over a long-term horizon and the proposed strategy refinements would make the portfolio slightly more efficient.** The impact of proposed refinements is shown by the improvement in the risk versus return profile of the overall PRGT strategy under the baseline assumptions as well as a shift higher in the return distribution (Figures VI.6a and VI.6b). The expected margin over the SDRi and the probability of meeting the 90 bp target is also expected to increase modestly (Figures VI.6b and VI.6c), while short-term risk statistics would be slightly more contained (Figure VI.6d). Under stress scenarios such as "widening spreads" or "rising yields coupled with low equity returns," the proposed strategy could still fall short of reaching the return target over the medium term, although still outperforming the current one (Figure VI.7a). Under these same stress scenarios, the portfolio is still expected to achieve the return target over a 10-year horizon with a reasonably high probability (Figure VI.7b).

**Figure VI.6. Current PRGT and Proposed Portfolio**

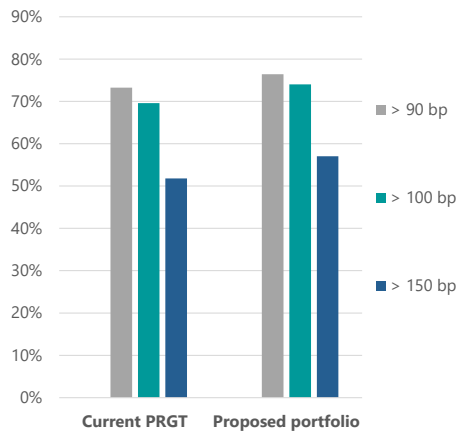
**a. Risk-return Profile**  
(over 10-year horizon)



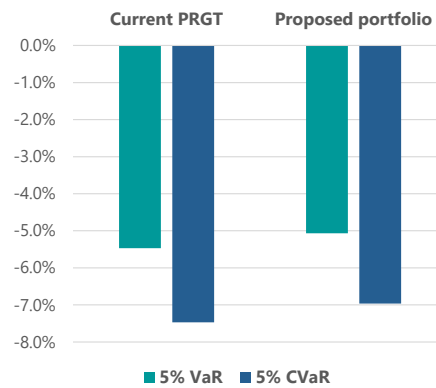
**b. Range of Expected Margin over SDR Interest Rate**  
(over 10-year horizon)



**c. Probability of Achieving Return Margins**  
(10-year horizon)

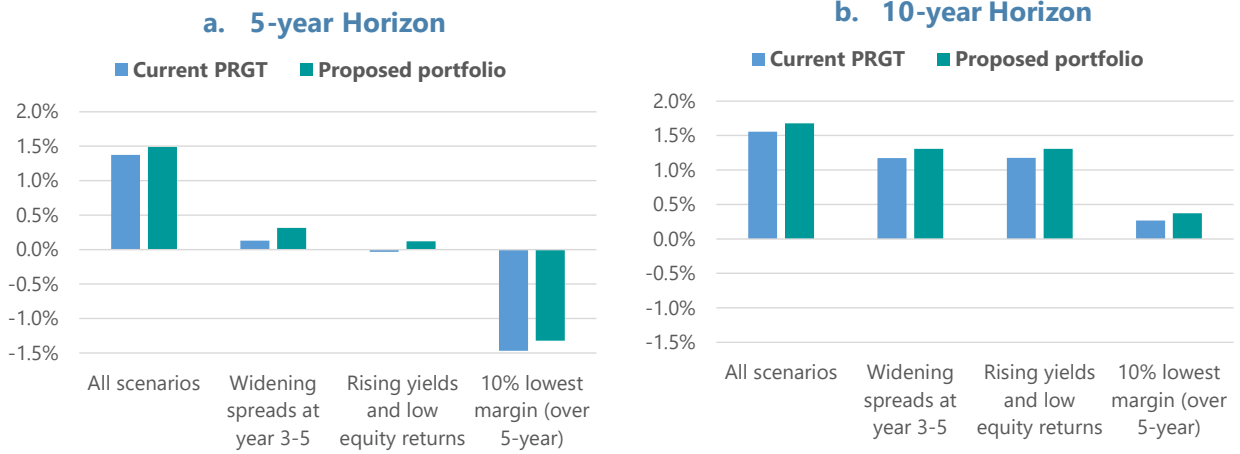


**d. Risk over One-year Horizon**



Sources: ORTEC and staff analysis, end-September 2021.

**Figure VI.7. Average Annual Return Margins over SDR Interest Rate Under Stress Scenarios**



Sources: ORTEC and staff analysis, end-September 2021. Each stress case captures approximately 2.5 percent of the overall simulated paths.

Table VI.1. Risk and Return Statistics for the Current EA, Proposed Portfolio, and Global 60/40

Real Portfolio Return	5-year horizon			15-year horizon		
	Current EA	Proposed portfolio	Global 60/40	Current EA	Proposed portfolio	Global 60/40
<b>Expected real return (ann.)</b>	<b>1.0%</b>	<b>1.4%</b>	<b>1.6%</b>	<b>1.6%</b>	<b>2.1%</b>	<b>2.3%</b>
Real return (ann.) - 99.5th Percentile	10.0%	12.9%	15.3%	6.2%	7.8%	9.4%
95th Percentile	6.3%	8.1%	9.8%	4.7%	5.9%	7.1%
75th Percentile	3.1%	4.0%	4.7%	2.9%	3.7%	4.2%
<b>Median</b>	<b>0.9%</b>	<b>1.3%</b>	<b>1.5%</b>	<b>1.6%</b>	<b>2.0%</b>	<b>2.2%</b>
25th Percentile	-1.1%	-1.3%	-1.6%	0.3%	0.5%	0.3%
5th Percentile	-4.1%	-5.1%	-6.1%	-1.3%	-1.5%	-2.3%
0.5th Percentile	-7.2%	-8.7%	-10.8%	-3.1%	-3.9%	-5.0%
5% VaR 1/	-4.1%	-5.1%	-6.1%	-1.3%	-1.5%	-2.3%
5% CVaR 1/	-5.4%	-6.7%	-8.0%	-2.2%	-2.6%	-3.5%
<b>Probability of Outperforming Real Return Target</b>						
Probability Real Return > 3 percent	25.8%	33.9%	38.0%	22.8%	34.8%	39.4%
Probability Real Return > 2.5 percent	31.0%	38.8%	42.7%	31.1%	43.1%	46.2%
Probability Real Return > 2 percent	37.5%	43.8%	46.5%	41.3%	50.4%	53.0%
Probability Real Return > 1.5 percent	43.5%	48.5%	49.8%	51.7%	59.3%	59.4%
Probability Real Return > 1 percent	48.8%	53.0%	54.5%	61.1%	67.7%	66.5%
Probability Real Return > 0 percent	62.3%	63.5%	62.7%	80.4%	82.2%	78.6%
<b>Asset Ratio - without payout</b>						
Asset Ratio Real - Mean	106.0%	108.6%	110.6%	130.7%	143.3%	150.8%
Asset Ratio Nominal - Mean	117.9%	120.9%	123.0%	176.9%	194.2%	203.8%
Probability of Asset Ratio Real < 100%	37.8%	36.5%	37.3%	19.6%	17.8%	21.5%
Probability of Asset Ratio Nominal < 100%	16.2%	18.9%	21.0%	2.7%	4.0%	6.6%
<b>Asset Ratio - with payout 2/</b>						
Asset Ratio Real - Mean	102.9%	103.8%	106.6%	120.4%	126.4%	136.6%
Asset Ratio Nominal - Mean	114.5%	115.5%	118.5%	162.8%	171.4%	184.5%
Probability of Asset Ratio Real < 100%	46.7%	46.5%	43.4%	31.3%	31.4%	31.4%
Probability of Asset Ratio Nominal < 100%	20.6%	26.7%	26.2%	5.6%	10.0%	11.7%

1/ The 5 percent value-at-risk (VaR) is the 5th percentile in the distribution of annualized returns over respective horizons, where 5 percent of the simulated returns fall below this number. The 5 percent conditional VaR (CVaR) measures the average of these worst 5 percent simulated returns.

2/ Based on the payout rule, at 70 percent confidence level the initial payout for the current strategy, the proposed portfolio, and a global 60/40 strategy would be USD 55 million, 85 million, and 65 million, respectively. Correspondingly, these initial amounts are assumed in the simulations and the payout grows annually at the same rate as the projected US CPI.

## Annex VII. Managing Director's Draft Responsible Investing Principles

### INTERNATIONAL MONETARY FUND

#### GENERAL PRINCIPLES FOR RESPONSIBLE INVESTING FOR THE INVESTMENT ACCOUNT AND TRUST ASSETS

[Insert date]

1. This statement sets out general principles for the responsible investment of the Fund's Investment Account and Trust Assets. These principles shall guide the Investment Oversight Committee and the staff members involved in the management of these assets.
2. The Fund's investment portfolios have been established to generate income to support the Fund's operations and strengthen its balance sheet. These primary financial objectives should be sought through responsible investment which will uphold the Fund's reputation and public confidence in the institution's broader activities.
3. Responsible investment should incorporate environmental, social, and governance (ESG) considerations in the investment decision-making process and ownership practices. The integration of ESG considerations into the investment process improves long-term performance by identifying portfolio risks and opportunities. Such opportunities can contribute to positive societal impact through investments aligned with environmental and social initiatives. Ownership practices which consider ESG issues can positively impact corporate behavior and in turn help generate sustainable shareholder value and societal benefits.
4. Investment managers appointed by the Fund should abide by the Fund's responsible investing principles set forth in this document and set high standards for their own corporate responsibility. As part of the initial selection process and ongoing oversight, the Fund should ensure that managers:
  - a. Have established policies and practices in place to conduct analysis and make investment decisions giving full consideration to material ESG factors and any potential financial or reputational risks.
  - b. Maintain capabilities for identifying ESG opportunities and risks in line with industry best practices and comply with applicable regulatory and reporting standards.
5. Investment managers appointed by the Fund should act as good stewards on its behalf. This stewardship should seek to enhance the long-term sustainable performance of investments through transparent and practical corporate engagement strategies giving full consideration

to material ESG factors. On the Fund's behalf, managers are expected to display good stewardship through their:

- a. Engagement with corporate management.
  - b. Exercise of voting rights.
  - c. Promotion of ESG best practices and transparency across the industry.
  - d. Reports on relevant stewardship activities.
6. In exceptional cases, some investments should be avoided if they are highly controversial and introduce acute reputational or financial risks which cannot be mitigated through active corporate engagement. Exclusions of these specific investments should follow accepted norms and be established following consultation with investment managers of the highest professional standards.
  7. The Fund will aim to support broad industry initiatives that advance responsible investment through industry collaboration.
  8. Under the authority delegated to her by the Executive Board, the Managing Director has approved this policy and will oversee its implementation. Practices for implementing these general principles will be developed by the Investment Oversight Committee as it deems appropriate. Significant developments in the practices will be reported annually to the Executive Board. In addition, the IMF Annual Report and Financial Statements will provide an overview of these developments in line with industry best practice.