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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/38-1

10:00 a.m., May 13, 2019

1. The Investment Account—Introducing Private Fixed Income in the Endowment Subaccount

Documents: SM/19/80

Staff: Attie, FIN; Brennan, FIN, Pham, LEG

Length: 27 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	I. Mannathoko (AE)
	H. Razafindramanana (AF)
	J. Di Tata (AG)
	A. Park (AP), Temporary
	P. Fachada (BR)
	P. Sun (CC)
	A. Guerra (CE)
L. Levonian (CO)	
R. Kaya (EC)	
	A. Castets (FF)
	K. Merk (GR)
S. Gokarn (IN)	
	C. Collura (IT), Temporary
	Y. Saito (JA)
J. Mojarrad (MD)	
	M. Merhi (MI), Temporary
	V. Rashkovan (NE)
	J. Sigurgeirsson (NO)
	A. Tolstikov (RU), Temporary
	B. Alhomaly (SA), Temporary
	U. Latu (ST), Temporary
	A. Tola (SZ), Temporary
	O. Haydon (UK), Temporary
	P. Pollard (US), Temporary

J. Lin, Secretary
O. Vongthieres, Summing Up Officer
D. Alcantara, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Finance Department: D. Al-Jarbou, P. Attie, M. Brennan, P. Farahmand, M. Gororo, M. Hasnain, T. Krueger, A. Kumtakar, W. Liu, A. Tweedie, Z. Xie. Legal Department: I. Luca, H. Pham, M. Racic. Office of Internal Audit and Inspection: F. Laclavere. Office of Risk Management: Q. Chen, A. Jamaludin. Secretary's Department: J. Lin.

Alternate Executive Director: R. Doornbosch (NE). Senior Advisors to Executive Directors: M. Choueiri (MI), M.Gilliot (FF), T. Ozaki (JA), A. Tivane (AE), M. Tolici (NE). Advisors to Executive Directors: A. Abdullahi (AE), A. Arevalo Arroyo (CE), O. Bayar (EC), M. Bernatavicius (NO), D. Cools (NE), I. Fragin (GR), U. Latu (ST), R. Lopes Varela (AF), P. Mooney (CO), C. Moreno (AG), A. Olhaye (AF), A. Park (AP), S. Vitvitsky (US), Y. Zhao (CC), K. Hennings (BR), J. Montero (CE).

1. THE INVESTMENT ACCOUNT—INTRODUCING PRIVATE FIXED INCOME IN THE ENDOWMENT SUBACCOUNT

Mr. Doornbosch and Mr. Tolici submitted the following statement:

We welcome the proposal to introducing private fixed-income investments in the Endowment Subaccount (EA) of the Investment Account (IA) to improve the portfolio's risk-return profile and would like to thank the staff for their good work.

We support the proposal to implement a 5 percent allocation in infrastructure debt for the Endowment Subaccount. We welcome staff's evaluation of the different options for introducing private fixed income in the endowment subaccount and their arguments to support a cost-efficient solution, next to diversification and risk-return considerations. As most of the current investments are in liquid securities, it seems warranted to allocate a small part of the EA to a rather illiquid instrument in order to enhance long term returns and reduce portfolio volatility.

Because of the low correlation with the EA's existing asset classes, the investment in infrastructure would bring portfolio diversification while benefiting from a strong credit protection and a sizeable and growing market. We believe this is an important first step. However, we suggest that the Board initiates a more in-depth discussion about responsible investment ambitions of the endowment, which would hopefully lead to a full-fledged sustainable investment strategy.

We broadly agree with the proposed investment framework regarding the private fixed income in the EA. As designed, the investment framework mitigates potential conflicts of interests and addresses reputational considerations, focuses on higher rated debt and with limited exposure to projects under construction to decrease risks. We note that the allocation would be externally and passively managed, under a buy-and-hold philosophy. Although it is acknowledged that the indirect model offers better diversification potential, there is no analysis about whether minimum diversification is at all achieved in the direct model, i.e. that the direct model could not even be an alternative considering the proposed size of the allotment in infrastructure debt. Staff's comments are welcome.

We also agree with the proposal to delegate additional authority to the Managing Director regarding certain investment modalities for the IA. This is consistent with the broad governance structure that has been adopted for the IA, with the Board delegating the implementation of investment strategies within the parameters set by the Board to the Managing Director and the Investment Oversight Committee. We concur with staff that further delegation to the Managing Director would allow for a more efficient implementation of the IA strategy by ensuring the operational flexibility needed to efficiently rebalance a portfolio with liquid and illiquid assets. Moreover, allowing the Managing Director to establish necessary rebalancing modalities is expected to reduce transaction costs while maintaining investment strategy over time. However, we suggest that this would be complemented by a more frequent reporting procedure to the Board, as warranted by market or other developments. Staff's suggestions on how to apply this are welcome.

Sustainable investment criteria e.g. environmental, social and governance (ESG) criteria should guide the Fund's investment decision in the future. In our view, the Fund should incorporate ESG criteria in its investment approach. We acknowledge that some ESG considerations are reflected in terms of reputational risk, arising from choices of companies and/or sectors that it would invest in, or long-term financial risks. The selection process of the fixed-income portfolio managers should focus on a strong alignment with the IMFs' objectives and risk tolerance and consider the ESG integration, i.e. how the ESG considerations are incorporated in their investment decision-making. Sustainability should be a key concern given our responsibility as a role model in the global financial system, and we would suggest the Investment Oversight Committee to attach the highest consideration to ESG criteria. Moreover, we invite staff to include rules in this regard in the next IA Review. Staff's comments are welcome.

Mr. Kaya and Mr. Stradal submitted the following statement:

We thank staff for their well-written paper and their outreach to our office. We support staff's proposal to implement a five percent allocation of the Endowment Subaccount in infrastructure debt. We concur that the modified asset allocation improves the risk-return characteristic of the portfolio and is compatible with its risk tolerance, including liquidity risk. Overall, we consider the economic and portfolio management arguments in support of the proposal sufficient on their own.

We agree with staff that an externally managed passive buy-and-hold portfolio is appropriate for this asset class in view of the reputational risks and the relatively high transaction costs involved. We tend to favor the indirect approach preferred by staff as we see the alignment of interests between the manager and the Fund, better diversification opportunities, and arms-length relationship with the individual borrowers as clear advantages. However, we are somewhat concerned by the higher fees in this type of arrangement. Could staff provide more specific data on the costs of management of the direct and indirect investment vehicles?

We take note of the heightened risk of perceived conflict of interest to the infrastructure debt. We are reassured by the mitigating measures embedded in the proposed way of managing the portfolio. We underscore the importance of the broadest geographical diversification possible to avoid any perceived bias. Could staff comment whether it is plausible to invest in infrastructure debt on all continents under the proposed investment arrangement?

We welcome the declared intention to invest predominantly in infrastructure projects in the operating stage, as well as in investment-grade equivalent instruments, which should not drop below 80 percent of the overall allocation as per footnote 20 on page 20. At the same time, we are cognizant of the limited control of the portfolio and higher manager dependency under the commingled investments. Could staff elaborate on the safeguards available to manage the broad risk factors of the portfolio after the initial investments?

Finally, we would have preferred more detailed numerical data in the report on historical returns, volatilities, and maximum drawdowns of the infrastructure debt compared to the existing constituents of the Investment Account, as well as their respective correlations and costs of management.

Mr. Geadah and Ms. Choueiri submitted the following statement:

We thank staff for the report, which presents the results of a feasibility study on introducing private fixed-income investments in the Endowment Subaccount (EA) of the Investment Account (IA), following the March 2018 IA review. We support the proposed decision.

Based on the premise that the EA has limited liquidity requirements, staff’s work indicates that private fixed-income stands out as the most suitable sector of the fixed-income market to include in the EA. Specifically, staff proposes that the 5 percent share of the EA earmarked for private fixed-income be placed in infrastructure debt, on the basis that it would provide the best diversification and risk-return opportunity. Figures 4 and 5 provide useful comparisons among key market segments that further motivate this proposal.

Specific new arrangements are required for the EA to invest in infrastructure debt, and we can support the staff proposals in this regard. The choice of the indirect approach seems reasonable as we would not be comfortable with the IMF being directly associated with individual projects in which EA assets are invested under the direct approach.

We are reassured that the proposed decision does not give rise to conflict of interest that could not be addressed appropriately under the existing conflict's framework.

Mr. Guerra, Ms. Arevalo Arroyo and Mr. Montero submitted the following statement:

We thank staff for its informative and comprehensive report on the feasibility study on introducing private fixed-income investments in the Endowment Subaccount (EA). We also thank staff for its useful outreach. We would like to state from the outset that we support staff's proposal that the 5 percent share of the EA earmarked for private fixed income, currently invested in DM corporate bonds, be replaced by infrastructure debt. We also agree with the amendments to the Investment Account (IA) rules needed to accommodate this new asset class and ensure enough flexibility in implementation. This said, we would like to add some comments for emphasis and qualification.

As highlighted in the 2018 IA Review, meeting the EA's 3 percent real return target over time will be challenging given the prevailing market environment. Thus, it was agreed to gradually refine the EA strategy to improve returns while containing risks. In this context, this is an appropriate moment to explore diversifying the EA's fixed-income allocation through the addition of private investments. The proposed investment in infrastructure debt seems to be reasonable regarding cost effectiveness and with relatively low correlation with the EA's existing asset classes; nevertheless, it will present some new challenges. In terms of yield levels, we would have expected more attractive additional returns (50-75 basis points seem low), especially if the Fund will be exposed to certain reputation risks (more on this below).

Even though the investment strategy will focus on infrastructure projects on the operation phase, which arguably are less prone to reputational/conflict of interest risks, we would caution against the likelihood of getting the Fund involved in infrastructure-related corruption cases, which are not an uncommon phenomenon across the world. We take positive note of the reassurance provided by the expected due diligence processes, as well as by the fact that investing through commingled funds makes it unlikely that the IMF would be associated with any specific project. However, it may be sensible to have a contingency plan in case of information leakages. Staff's comments are welcome. Furthermore, as mentioned before, given the relatively modest amount of additional income generated by this change in investment -about USD 2 million a year- we should assess, after an appropriate time, if the benefits have outweighed the costs of reputational risks as well as other costs.

Consistent with current market practice, we are willing to accept limited amounts of securities below the investment grade (IG) threshold or loans to projects that are on the final stages of construction. We would have preferred a more comprehensive discussion of the limits to the investment policy in securities below IG (see footnote 20). We take note that industry standards set IG-equivalent instruments representing no less than about 80 percent of the allocation and that instruments rated below IG would generally have a rating equivalent to BB- or higher. Will these limits be strictly enforced? In this regard, we note in the proposed amendments to the IA Rules that the Managing Director may establish modalities for allowing limited investment in infrastructure debt that is rated below BBB- at time of acquisition. We would ask staff to comment on the guidelines to determine such modalities. From the investment policy we understand that the limits pertain to the time of purchase of the assets. How are these limits be used to guide the divestment policy? In particular, we expect a cautious approach to the divestment policy when an asset ceases to meet the required rating threshold. Notwithstanding this decision, we believe the Board should be clear that this policy does not set a precedent regarding the credit quality of other asset allocations, which must be discussed on a case-by-case basis.

Mr. Fanizza and Ms. Collura submitted the following statement:

We thank staff for the clear paper and the outreach.

In light of the analysis and the conclusions of the feasibility study, we agree with the proposal to earmark 5 percent of the allocation for private fixed-income investments in the Endowment Subaccount (EA), and specifically for infrastructure debt. We agree with the proposed changes to implement the new investment arrangement.

We value two features related to the choice of the infrastructure debt: i. the apparent lower credit risk, and ii. the increased gains in risk-return efficiency at the overall EA portfolio level. We are aware of the relatively limited amount of resources that would be invested into this instrument; yet, we consider that these features go into the direction of promoting higher returns, while not increasing risk substantially – which we welcome. It is important to move toward a fully operational "new" income model to rely less on lending income.

In our view, the most sensitive aspect of the proposed investment arrangement is the risk that it may raise perceptions of conflict of interests (COI) and reputational risks, including those related to environmental and governance considerations. We have the sense that the choice of the indirect investment model, in addition to the COI framework and the current rules, can effectively mitigate these risks.

Mr. Di Tata and Ms. Moreno submitted the following statement:

We thank staff for the informative paper and the bilateral outreach before this meeting.

We agree with the paper's proposal and support the decision of introducing private fixed income in the endowment subaccount (EA). As noted in the paper, the EA is invested almost entirely in liquid market securities, which is unusual for a long-term portfolio. The main benefit of introducing private fixed income is diversification by means of acquiring a new instrument with the desirable characteristics of having a higher expected return without compromising the risk profile. Although private assets are a less liquid investment, this is not necessarily a problem as the EA has limited liquidity requirements. Moreover, private fixed income instruments offer exposure to a large universe of borrowers and strong credit protection for lenders.

We agree with the staff's recommendation that the 5 percent allocation earmarked for private fixed income be invested in infrastructure debt. Such a strategy is also in line with current global initiatives to enhance the role of infrastructure as an investable asset class. On the rationale for infrastructure debt, we take note that this asset class is attractive to long-term investors, such as insurance companies and sovereign and pension funds. Market depth is high while the diversification benefits and scalability of infrastructure debt makes it well-suited for a strategic portfolio allocation. In addition, long-term credit performance is more favorable than for equivalently rated corporate debt, reflecting that infrastructure loans are backed by the projects they finance.

The fact that infrastructure projects face different risks depending on the stage of development poses some challenges for the investment decision. We agree with staff that the Fund should avoid the construction phase, which carries a greater risk, and focus primarily on the operational phase of infrastructure projects. Other risks related to currency and revenue stability, or the political and regulatory environment, will have to be addressed and mitigated. Can staff explain how the Fund, through the mandate given to the external manager, can better address and mitigate these risks?

Regarding the investment arrangements, we agree with staff on the buy-and-hold approach, which will reduce costs and maximize the likelihood of harvesting the illiquidity yield premium over time. We also support the choice of an indirect investment model under which investments will be managed in a commingled fund, at least for the time being. The trade-offs involved are important, but we agree with staff that at this stage, given the amount to be invested, it is more practical and cost-effective to use the indirect approach, which also has higher diversification prospects. These benefits, however, come at the expense of more limited control over investment guidelines than under the direct approach. It would also be important to maintain a low risk profile and focus on Investment Grade instruments.

We agree that some flexibility is required in setting eligibility requirements for individual loans when investing in commingled funds, since the fund's investment guidelines must be acceptable to all co-investors. We also agree with the proposed modification to the rebalancing policy that incorporates some flexibility to improve efficiency and reduce transaction costs. In this regard, we support the proposed amendments to the IA Rules specified in Box 1.

We welcome the paper's emphasis on conflicts of interest and reputational considerations. As noted by staff, the three pillars of the IMF's Conflict of Interest (COI) Policy, namely the separation of responsibilities, the Fund's COI policies and procedures, and management oversight play a key role against actual and perceived COI risks, including for private infrastructure investments. The perception of COI will be mitigated by outsourcing the day-to-day management of the portfolio to external managers with a broad mandate and a passive investment approach. The key issue is that Fund staff should not be involved in the selection and management of specific loans.

Regarding reputational risks, staff's due diligence during the selection process and its oversight of external managers constitute key risk management issues. We understand that at the beginning of its mandate the asset management company will receive investment guidelines consistent with a multi-country investment approach and project creditworthiness, and that proper attention will be given to factors such as environmental and governance considerations. As noted by staff, under the commingled fund option, it is unlikely that the Fund would be associated with any particular project.

Lastly, is staff planning to review the 5 percent allocation for private fixed income in the future based on experience?

Mr. Mouminah, Mr. Alkhareif and Mr. Alhomaly submitted the following statement:

We thank staff for an informative paper and for their outreach, which helped us clarify a number of issues. We support the proposed decision and would like to highlight the following points.

We support the allocation of 5 percent share of the Endowment Subaccount (EA) earmarked for private fixed income to infrastructure debt. Given its limited liquidity needs and long-term investment horizon, the EA portfolio has the capacity to absorb less liquid asset classes with attractive illiquidity risk premium. The inclusion of the infrastructure debt should enhance the portfolio's risk-return profile and offer diversification benefits due to its relatively low correlation with the EA's existing asset classes. We note from Figure 5 that trade finance, aviation loans, shipping loans, and timber also offer diversification benefits to the EA's portfolio. However, we agree with staff that these segments would require more complex management arrangements due to the limited universe of asset managers and relatively low market depth. According to Figure 5, the tenor of infrastructure debt could range from 5 to 30 years. Since investments in infrastructure debt would be managed passively according to a buy-and-hold philosophy, we would welcome staff elaboration on the targeted tenor of infrastructure debt to be included in the EA.

From a macroeconomic perspective, the importance of infrastructure investment to promote sustainable and inclusive growth cannot be overemphasized. Indeed, private sector and institutional investors have an important role to play in funding infrastructure gaps. In this connection, staff has rightly highlighted the emphasis by the G20 on infrastructure development and financing.

At this stage, we see merit in managing the investment in infrastructure debt through commingled investment funds to, among others, achieve greater diversification. That said, separately managed account also offers important benefits, as highlighted in Figure 11, and may become more appealing in the future as the market grows. Therefore, we would expect an update from staff once such condition materializes.

On portfolio rebalancing, we see merit in staff's proposal to allow for some operational flexibility in the rebalancing process to reduce transaction costs without impacting the overall investment strategy. We expect that the process would remain rules-based and not allow for discretion on market timing.

Finally, on conflicts of interest or potential reputational risks for the Fund, we are reassured by the staff's assessment, confirmed by an external counsel, that the proposed package is appropriately designed to minimize these risks. In this connection, selection of managers of the highest professional standards with proven skills and track records, providing broad mandates, and pursuing a passive investment approach will be crucial.

Ms. Levonian, Mr. Heo, Mr. Mooney and Ms. Park submitted the following joint statement:

We thank staff for their comprehensive paper, as well as their briefing sessions with OEDs which have proved most helpful. We are generally supportive of the diversification of the 5 percent allocation of the Endowment Subaccount earmarked for private fixed income, currently invested in Developed Market corporate bonds, to be invested in infrastructure debt.

As an overarching point, we see the Board's role in the governance of the Investment Account as endorsing a broad strategic direction, with the implementation of investment strategies within the parameters set by the Board delegated to the Managing Director and the Investment Oversight Committee. Future technical changes that fall well within the broad strategic direction could be reported to the Board. The Board does, however, expect to be informed about developments in the Investment Account at least annually, and more frequently as warranted by market or other developments. In this respect, we welcome the introduction of technical briefings to the Board on the performance of the Investment Account ahead of the publication of the Annual Report in FY2018.

Mr. Saito and Mr. Minoura submitted the following statement:

We thank staff for the comprehensive paper which provides detailed feasibility studies on introducing private fixed-income investments in the Endowment Subaccount (EA) of the Investment Account (IA), as well as the informative outreach. As we pointed out in the March 2018 Review of the IA, given the current high valuation of risk assets and the compressed term premium, it is reasonable to include a modest allocation to less-marketable investments and benefit from earning an additional illiquidity premium. Therefore, we see merits in diversifying the EA's fixed-income allocation through the addition of private investments. As we broadly concur with the thrust of the staff's appraisal, we support the proposal that 5 percent allocation earmarked for private fixed income be invested in infrastructure debt, and will give some comments as follows:

Introducing Infrastructure Debt in the EA

We support the findings of the feasibility study that infrastructure debt is considered as the most suitable sector of the private debt market to include in the EA. Given attractive yield levels within the universe of investment grade (IG) credit, low sensitivity to the business cycle, relatively low correlation with the EA's existing asset classes, broad investment opportunities and potential to grow, it is reasonable to invest in infrastructure debt. In addition, we positively take note of the simulations results that the EA's efficient frontier shifts to the upper left corner with the addition of infrastructure debt, even under a conservative assumption (0.6 correlation).

Going forward, further amendments to the investment allocation could be also considered. As the feasibility study exhibits many advantages of infrastructure debt, more allocation to infrastructure debt would be an option to meet the 3 percent real return target over time given the prevailing market environment. Staff's comments are welcome.

Investment Arrangements

Broad Implementation Parameters

Delegating management of investments in infrastructure debt to external manager is consistent with arrangements in place for the EA's investment in public markets, and expected to mitigate actual or perceived conflict of interests (COIs). Regarding selections of asset managers, we take note that staff sees benefits in exploring partnership opportunities with large insurance companies, could staff elaborate more on advantages of such partnerships with insurance companies? Proposed passive approach according to a buy-and-hold philosophy is common for private investments and particularly well suited for infrastructure debt, given its restricted marketability.

Regarding a choice between direct and indirect approaches, we take note of the staff's view that indirect access through commingled funds is the most practical and cost-effective approach and would achieve greater diversification. Having said that, staff also suggests that the indirect approach incurs slightly higher fees, and thus we encourage staff's more detailed explanations on cost-benefit comparisons between two approaches. Going forward, we also encourage staff's continuous monitoring on a suitable approach against market developments in the future.

Specific Implementation Considerations

As a prudent initial step into private markets, we support the staff's proposal to focus on the lower risk segment of the infrastructure debt market, by targeting IG-equivalent debt and thereby limiting exposure to debt with significant construction risk. At the same time, it is understandable that some flexibility is required in setting eligibility/divestment requirements, given that initial investments would be via commingled funds. We also support that currency exposure for infrastructure debt investments would be denominated in or hedged back to the U.S. dollar, which is consistent with the existing arrangement in the EA's passively managed fixed-income component.

Other Implementation Considerations—Portfolio Rebalancing

Given the illiquid nature of the investments and the lead time necessary to invest in new funds, we support the staff's proposal to modify the rebalancing policy away from the current approach that requires rebalancing to the exact Strategic Asset Allocation (SAA) weights, which is consistent with a standard practice for institutional investors.

Conflicts of Interest (COI) and Reputational Considerations

As staff rightly pointed out, investments in private infrastructure debt may raise perceptions of COI, and thus additional consideration and caution would be needed. In this light, the proposals to outsource the day-to-day management of the portfolio to external asset managers and take buy-and-hold (passive) strategy will contribute to mitigating the perception of COI.

Nevertheless, while staff assess that the perceived COI for possible investments in projects in member counties with IMF-supported programs to be less pronounced than it would be for investments in government debt, investments in key infrastructure projects in program countries could evoke perception of COI. Could staff elaborate more on how staff mitigate risks of COI related to IMF program countries?

Timeline for Starting Investment

Finally, we invite staff's explanation on a current schedule/prospect for initiating investments in infrastructure debt.

Mr. Castets and Ms. Gilliot submitted the following statement:

We thank staff for their well-argued and well-considered report on the proposal to diversify the allocation of assets of the endowment subaccount (EA) of the Investment account. We support the diversification option contemplated to place in infrastructure debt the 5 percent share of the Endowment Subaccount earmarked for private fixed income and currently invested in developed-market (DM) corporate bonds.

This proposal comes in response to the review of the investment strategy by the Board in 2018 which aimed at improving the risk/return profile of the EA portfolio by diversifying part of its 60 percent fixed-income allocation recognizing all the while that achieving its 3 percent real return target over time would be challenging in a context of continuously low interest rate environment. In this respect, we would like to know if and when, beyond this strategic revision of the EA assets allocation, staff will reconsider the return target. This suggestion comes also in line with the gradual evolution of the strategy to increase diversification and return through, inter alia, the decision implemented this year to reallocate a 5 percent from DM sovereign bonds to DM corporate bond pending the outcome of the feasibility study on new diversification options. The share (5 percent) of the allocation seems perfectly consistent with the "alternative" nature of this asset class and in line with the standards of market participants' practices, including the main asset managers. The estimated return improvement of at least 50-75 bps net of fees under a conservative approach stands moreover as an attractive step forward. Does staff contemplate moving toward another class of asset or a less conservative approach on infrastructure debt in the medium-term to increase this return? if yes, could they provide information on the coming investment strategy and expected return?

We indeed appreciated the detailed analysis of the rationale for choosing infrastructure debt among the wide range of private fixed-income sectors. We agree that across the various asset classes, infrastructure investment provides attractive yield levels, low credit risk and default while offering high market depth. The conservative approach to target Investment Grade-equivalent debt under a buy-and-hold strategy (which are illiquid by nature) and to limit the exposure to the construction risk seems adequate and relevant in this context. As duly underlined in the report, the phase of the project life cycle (construction vs. operational) is the most relevant differentiator of credit risk. We note that the total proposed investment in infrastructure debt is about US$350 million and would be invested in two or more funds, which altogether could include between 50 and 100 projects. We thank in advance staff to keep the Board informed of such undertaking.

We fully support the prudent approach under the indirect model of investment through a commingled investment fund. Although this approach presents trade-offs, it would lower the risks related to potential conflicts of interest and IMF’s reputation as the Fund would not the lender of record and there would be an additional oversight from other co-investors. The strict selection of external asset managers is indeed key to mitigate reputational risk. consistent with the Fund’s reputation, due emphasis will need to be given to diligence processes including the creditworthiness of the project, but also environmental and governance considerations and we appreciate staff mentioning these aspects in the report.

Mr. Tombini, Mr. Fachada and Ms. Hennings submitted the following statement:

We thank staff for the report and the outreach to our office. After the refinements to the investment strategy of the Endowment Subaccount (EA) approved by the Executive Board in Mach last year, we welcome the finalization of the feasibility study on introducing private fixed-income instruments in the EA.

We support staff’s proposal to allocate 5 percent of the EA portfolio in infrastructure debt. We concur with staff that the EA is highly concentrated in liquid instruments, and given its long-term nature and limited liquidity requirements, the portfolio could benefit from some “illiquidity premium.” At the same time, the market for investment in infrastructure debt is promising, with a broad range of sectors requiring long-term financing and with low correlation between project life and business cycles. However, the higher expected returns are the compensation for holding less liquid assets for longer periods, facing among others the risk of changes in long-term development patterns and government regulations (for example, environment regulations). Although certain risks can be managed, some projects may rely on overoptimistic long-term cash flow assumptions and the stability of regulations in general.

The implementation of the proposed strategy should consider the reputational risk for the Fund and the required changes in rules and regulations for the Investment Account (IA). We agree with staff`s assessment that the external management of the investment in infrastructure debt mitigates actual and perceived conflict of interest. However, if on one hand outsourcing the investment strategy reduces conflict of interest concerns, on the other hand requires better control systems and communication with the managers.

The increase in degrees of freedom for investment allocation should be accompanied by adjusting governance and reporting practices. The successive refinements approved by the Executive Board in the composition and management of the EA represent a gradual evolution towards more diversification and investment autonomy. As our chair underscored in previous Board meetings, the outcome of the changes in the investment strategy should be closely monitored by the Executive Board. Although we do not want to micromanage staff, we do believe that an annual report detailing the investment strategy and the portfolio performance is not enough. In this regard, we reiterate our call for the Board (or at least a committee of Executive Directors) to have access to more frequent reporting. This would certainly increase the Board's accountability regarding the investment strategy.

Mr. Merk and Mr. Fragin submitted the following statement:

First, we thank staff for the insightful paper and the detailed assessment on the various aspects that have to be taken into account for the investment in the new asset class.

Putting aside our initial concerns against the introduction of a new asset class, we can concur with the proposed decision to modify the "Rules and Regulations for the Investment Account", if transparency of the investment decisions and activities, and timely information for the Board are ensured. The amendments comprehend modifications necessary for the investment in private infrastructure assets, as well as the provision of more flexibility for the Management to take decisions on investments and rebalancing in this segment. This includes potential acceptance of assets with lower than the Investment Grade for limited amounts, implying further expanded responsibility for the Management. We therefore expect to have discussions in future Annual Investment Reports and additional timely information by the Investment Oversight Committee where appropriate.

At the same time, we would ask for confirmation that future amendments that go beyond the currently proposed approach of the investment strategy will be subject to Board consultations. This clarification appears indicated since the document refers on several occasions to "initially focusing on infrastructure debt" and with an initial limited allocation".

Preserving the real value of the endowment and therefore reaching the 3 percent target rate should have highest priority. This will allow for small pay-outs from the endowment to cover budget expenses if necessary. Given the challenges to achieve this target rate, we are open for the investment of a small amount in the new asset class, considering that the probability to reach higher yields compared to the current corporate bond investment could potentially be increased. The proposed investment modifications appear sustainable as they are based on a moderate strategic reallocation of the assets while ensuring a continued conservative investment approach.

However, we are not yet fully convinced that the expected higher net returns of the IG-equivalent infrastructure investment will eventually materialize. On the basis of the data available in this document the yield increase will be 50-75 bp net of fees based on conservative estimations. However, it remains unclear to what extent fees would be higher for the preferred indirect approach compared to a direct investment approach. We would appreciate if staff could provide more detailed information on the fees expected in the context of the indirect approach.

In the context of cost-benefit-considerations all efforts are welcome to keep the costs for an external manager limited. Staff's proposal to cooperate with an insurer or another institutional investor who invest their clients' portfolio in parallel with their own investments appears a reasonable approach for a cost-efficient investment.

Other questions occur in the context of investments in rather illiquid assets: How to manage them in times of rising interest rates which might not be an unrealistic scenario for the near future and mid-term? Here, more details on the investment strategy would be welcome. Moreover, another issue could arise in case of a substantial underperformance of an investment project against the backdrop of the "hold-strategy" (e.g. substantial downgrading because of immense project delays or operational difficulties). Staff comments are welcome.

We take positive note that the proposed investment in the new asset class has the potential to generate positive external effects, which is a virtue of infrastructure debt. Nevertheless, while a focus of the Fund's investment on sustainable projects in renewable energy, environment and social protection, healthcare and education, would be welcome, it needs to be acknowledged that the prime purpose of the investment in private infrastructure is to improve the portfolio for achieving higher yields of the endowment.

Finally, against the backdrop of a rather difficult selection of projects, governance and transparency of infrastructure investment compared to other assets of the portfolio so far, which criteria for the selection of investments (including reference projects and examples) are foreseen?

Mr. Gokarn and Ms. Dhillon submitted the following statement:

We thank staff for the paper on introducing private fixed income in the endowment subaccount and the outreach to our office.

We broadly support the proposal to make a five percent allocation of the Endowment Subaccount in infrastructure debt. Relative advantages over other sectors in the private debt market, attractive yield levels, a boost to the EA's expected return and greater diversification, stand out as key attractors. Implementation-wise, we note that the proposed change is accommodated within the existing conflicts framework. The outcome of the feasibility study provides a convincing case supporting the staff proposal. In particular, we see value in this strategy being aligned with the global initiatives to enhance the role of infrastructure as an investable asset class. Therefore, within the strategy outlined and the related mandate, would there be flexibility and diversity in terms of the regions where the investments would flow and more narrowly, would the exposure to sectors within infrastructure debt be defined?

Coming to the investment arrangements, we take comfort that infrastructure debt would be externally managed in consistence with the ongoing arrangement of EA investments. As is with other investments, this too is not a straightforward area and will require a deep assessment of risks, market knowledge and due diligence. We concur with staff's rational recommendation on an indirect approach, the arms-length relationship provided by outsourcing to specialized asset managers and investments managed passively according to a buy-and-hold philosophy. Looking at the counter perspective, adopting a direct approach in the future has too been flagged. Staff also sees benefits in exploring partnership opportunities with large insurance companies. Could staff offer more details on the specific benefits of insurance companies and the cost comparisons of the two approaches?

Finally, on implementation considerations, we support that IOC, as authorized by the Managing Director, would refine rebalancing modalities to allow for operational flexibility, while ensuring that deviations from the SAA are minimized. However, as suggested by Mr. Doornbosch and Mr. Tolici in their Gray statement, we too suggest that this be complemented by a more frequent reporting procedure to the Board.

Mr. Razafindramanana, Mr. Sidi Bouna and Mr. Carvalho da Silveira submitted the following statement:

We thank staff for a well-articulated report on “The Investment Account—Introducing Private Fixed Income in the Endowment Subaccount.”

We support the proposal to allocate 5 percent of the Endowment Subaccount (EA) earmarked for private fixed income to infrastructure debt. Staff have made a convincing case for considering the investment of part of the EA in infrastructure debt, following the Board’s call for exploring the feasibility of diversifying a fraction of the EA through investments in private markets.

We welcome the analysis in the report indicating that the introduction of private infrastructure debt in the EA is likely to improve its performance. While private infrastructure debt is less marketable than other more liquid categories of assets, we note that an illiquidity risk premium compensates investors for investing in such assets. However, we agree that it would be prudent to favor investment grade-equivalent debt while also avoiding, to the extent possible, infrastructure debt with elevated construction risks.

The advantages of investing in infrastructure debt have been clearly spelled out in the report. In addition to the illiquidity premium associated with such an investment, we also note the broader variety of potential issuers and the stronger protection against credit risk. The steady growth of the sector, as shown in Figure 7, and its lesser sensitivity to the business cycle are also favorable factors.

The investment arrangements proposed by staff are broadly adequate. The choice of a passive investment strategy combined with an indirect approach to investing by external specialized asset managers is appropriate. Furthermore, these arrangements, along with the IMF's conflicts of interest framework, should help mitigate the risks associated with investing in infrastructure debt. We note the discussion in paragraph 7 on the liquidity requirements of the EA. Under the EA payout policy framework, the Executive Board has delayed the initiation of EA payouts until FY2021. Do staff envisage any changes to the proposed investment arrangements, should the Board decide to initiate payouts after FY2021?

We support the proposed amendments to the investment account rules, including the proposal to delegate to the Managing Director the responsibility of determining eligible investments, as well as divestment requirements. We also approve the proposed changes to the rebalancing policy.

Mr. Mojarrad and Mr. Nadali submitted the following statement:

We thank staff for an informative paper that explores introducing private infrastructure debt in the endowment subaccount (EA) of the investment account (IA) and proposes relevant amendments to the IA rules and regulations. Complementing four other strategic refinements to the EA investment strategy approved by the Board in March 2018, the addition of private infrastructure debt offers the best diversification and risk-return opportunity, can be cost-effective to implement, and is well-aligned with initiatives to enhance the role of infrastructure as an investable asset class and increase private sector engagement in filling the global infrastructure funding gap. We concur with staff analysis and conclusion, support the proposed decision, and offer the following remarks:

We agree that the EA has limited liquidity requirements, and note staff findings that the illiquidity risk premium is more likely to be captured by investing one quarter of the existing 20 percent EA's allocations to DM corporate bonds in private fixed-income instruments rather than in private equity partnerships. ¶15 and Figure 5 highlight the clear advantages of infrastructure debt over other sectors of the private debt market in improving the EA's risk-return profile, including attractive yield levels within the universe of investment grade credit, the relatively low correlation with the EA's existing asset classes, the scalability of infrastructure debt due to its deep and growing market, and the existence of several reputable and well-established asset management companies to support the EA's requirements.

¶20 indicates there are no material credit risk difference between infrastructure debt in DM and EM markets, and that credit losses experienced have been concentrated in the energy sector. Moreover, ¶36 indicates that infrastructure project loans in many EM countries are denominated in US dollars. Does this mean EA infrastructure debt portfolio would include infrastructure project loans in both DM and EM markets, thereby altering the EA's strategic asset allocation (SAA) of 85 percent DM and 15 percent EM? Would energy sector be excluded from the private infrastructure debt in the EA? We appreciate staff comments.

Footnote 14 indicates the absence of a benchmark for private infrastructure debt as an asset class prior to 2006. Given the continued growth of the infrastructure debt market, as evidenced by significant investments in alternative assets by sovereign wealth funds, insurance companies, and pension funds over the past decade, could we now assume the existence of widely-accepted benchmarks for passive management of private investments, including infrastructure debt? Staff may wish to comment.

For reasons enumerated by staff, we agree with the broad and specific implementation parameters required for the EA to invest in infrastructure debt. These include externally-managed passive investment carried out indirectly via an investment fund, considering publicly registered debt in addition to private loans, focusing on investment grade debt with limited exposure to construction risk, allowing some flexibility in setting both eligibility requirements and divestment regime for investments made through a commingled fund, having currency exposure for infrastructure debt investments denominated in or hedged back to the US dollar, and refining rebalancing modalities to allow for the passive component of the EA to be reweighted as close to the SAA as is practical. Could staff confirm if insurance companies offering co-investment partnerships with the Fund would be selected over traditional asset management firms in externally managing the EA's 5 percent allocation to private infrastructure debt? Moreover, given that the direct approach could become more compelling in the future as the market continues to grow and evolve, we would look forward to staff informing the Board if the direct approach becomes more suitable in the future.

Finally, as confirmed by the external counsel, we agree that the Fund's existing conflicts of interest (COI) framework and the proposed investment arrangements are adequate to mitigate COI and potential reputational risks arising from the introduction of private infrastructure debt in the EA.

Mr. Sigurgeirsson and Mr. Bernatavicius submitted the following statement:

We thank staff for their thorough and informative report. In the context of the current interest rate environment and the challenges facing the Endowment Account (EA) in meeting its 3 percent real return target, we can support the proposed decision to place a 5 percent share of the EA in private infrastructure debt.

We note that many investors with a long-term investment horizon increasingly allocate sizable shares of their portfolios towards private investments. We agree with the conclusions of the staff's feasibility study and the cross-comparison, which demonstrates, that infrastructure debt presents a suitable sector of the private debt market to include in the EA. We recognize the potential benefits of including private infrastructure debt, such as diversification, lower sensitivity to economic fluctuations, attractive expected yields and a relatively low correlation with the existing asset classes. We also support the suggestion to increase flexibility in the rebalancing regime, which seems reasonable given the illiquid nature of private infrastructure investments.

The Endowment Account appears to be well diversified. In general, it is important to be mindful when allocating small portions of portfolios to new asset classes that can contribute to more complexity and increase costs, and sometimes higher than what realistically can be gained from further diversification. The use of external managers makes it even more important to contain costs. However, with the suggested reallocation from corporate bonds to infrastructure debt, this may not be a problem in this instance.

Infrastructure debt is usually characterized by a monopoly utility that provides services, which are indispensable in nature. Roads, bridges, electricity networks, and water pipelines are examples of infrastructure that are extremely difficult or costly to replace with competing solutions. Therefore, higher risks in these investments are unusual in nature. The higher yields reflect the illiquidity of investments and therefore it can be argued that they are suitable products for long-term buy-and-hold investors.

Reputational considerations will need to be considered to minimize perceptions of conflict of interest (COI) and the general status of the Fund. We agree, that the proposed investment arrangements, i. e. the proposal to outsource the day-to-day management of the portfolio as well as the buy-and-hold (passive investment) strategy, will mitigate the perception of COI. We also take note of staff´s consultation with the external counsel, who has confirmed this assessment. Nevertheless, it is important that the Investment Guidelines include clear conditions to ensure that the investments are made in a way that are considered ethical, environmentally sound, and acceptable from a social and governance viewpoint. For example, it could be considered that the Investment Guidelines be formulated on the basis of PRI (Principles of Responsible Investments – developed by the UN) and the Task Force on Climate Related Financial Disclosure (TCFD)'s conclusions and recommendations on reporting on carbon investments.

We agree that despite the current proposal being motivated mostly by the financial benefits, it could also have the potential to generate positive externalities, as the G20 has encouraged measures to address the persistent infrastructure financing gaps.

Mr. Mahlinza and Mr. Tivane submitted the following statement:

We thank staff for an informative paper which sheds light on the feasibility of allocating the 5 percent share of the Endowment Subaccount (EA) to long-term private fixed income investments. In light of the justification presented in the paper, we support the proposed decision to amending the Rules and Regulations for the Investment Account (IA). We would like to highlight a couple of points for emphasis.

We agree that investment in infrastructure assets provides an avenue to improve the strategic portfolio allocation of the fixed income component of the EA and will enhance diversification of the portfolio. In addition, this asset class could enhance the EA's risk-return efficiency. That said, great effort has to be placed on the selection of investment managers and their management.

We underscore the importance of ensuring appropriate safeguards to mitigate perceived conflict of interest (COI) from the introduction of infrastructure debt in the EA. While it is not possible to completely eliminate such perceptions, the proposal to employ external managers with broad mandates and a passive investment approach should mitigate COI. In this regard, we encourage enhanced oversight of investment decisions undertaken by asset managers as well as continuous assessment of this risk.

Finally, we concur with staff that infrastructure investment has the potential to generate positive externalities. This proposal therefore aligns with the global commitment in support of infrastructure investment. We also believe that the Fund's participation in the infrastructure debt market will help connect the public and private sector to economic opportunities by harnessing investments in renewable energy, social and human development.

Mr. Inderbinen and Mr. Tola submitted the following statement:

We thank staff for their careful analysis of the feasibility of introducing private fixed-income investments in the Endowment Subaccount (EA) of the Investment Account (IA). We support their well-argued proposal to place the 5 percent share of the EA earmarked for private fixed income in infrastructure debt. Such a change in the investment strategy should increase the portfolio's returns at manageable financial and non-financial risk. We also support the proposed amendments to the IA Rules and Regulations and the envisaged investment arrangements.

EA investment should be guided first and foremost by financial considerations. Infrastructure debt offers clear advantages compared to other private debt instruments, including an attractive yield, low correlation with the EA's existing assets, partially built-in inflation protection, a low default risk and high recovery rates. While investing in infrastructure carries broader benefits, not least by enhancing long-term growth prospects, this should not be a criterion for EA investment decisions.

We agree with the proposed investment arrangements. Employment of external managers has worked well for EA's investment in public markets. We also agree with the buy-and-hold approach, which maximizes the likelihood of harvesting the liquidity premium over time and mitigates actual or perceived conflicts of interest (COIs). Further, it appears reasonable that investments be carried out indirectly via an investment fund. The indirect access through commingled funds is the most practical and cost-effective approach and allows for broader diversification. In addition, it will prevent any association of the IMF with the underlying projects.

We agree with the focus on the lower risk segment of the infrastructure debt market. Focus on the IG-equivalent debt segment is warranted by the need to limit credit risks. At the same time, some flexibility is required when investing in commingled funds. To retain this flexibility, we agree that the Managing Director be delegated the responsibility to determine investment arrangements that target funds of IG quality, and to amend paragraph 33 of the Rules accordingly. In this regard, we underline the importance of selecting highly experienced and reputable managers with robust investment processes, as well as continuous oversight of managers. We also suggest a regular (e.g. annual) reporting on infrastructure debt investments to the Board.

We fully support the envisaged operational flexibility for the rebalancing processes. We also agree with the flexibility envisaged for the divestment regime and with the approach to currency exposure.

External management of the portfolio and the buy-and-hold strategy are key elements to mitigate COI perceptions. Mitigating risks of COI and potential reputational risks is important. These risks may be particularly pronounced in the case of infrastructure debt investments, since non-public information may have a higher relevance in illiquid markets. Also, potential reputational risks could arise when a project entails governance, environmental or land conflict issues. The delegation of investment decisions to external managers, the passive investment strategy, and the expected small share of IMF financing in individual projects should, however, minimize any perception of the Fund's control of, or benefit from, such projects. Finally, we fully agree on the importance of considering environmental and governance issues.

Ms. Mahasandana, Mr. Mahyuddin and Ms. Latu submitted the following statement:

We thank staff for their comprehensive report and extensive efforts in studying the potential feasibility and appropriateness of introducing private fixed income in the Endowment Subaccount (EA) of the Investment Account (IA).

Based on the feasibility study, we can agree with staff's proposal for the 5 percent share of the EA earmarked for private fixed income to be placed in infrastructure debt. Staff has presented a compelling case that infrastructure debt provides the best diversification and risk-return opportunity compared to other sectors in the private debt market. In all, this could potentially support the efforts toward achieving the EA's investment objective of a real return of 3 percent over the long term. In this regard, we note the estimated return improvement of 50-75bps net of fees on the 5 percent allocation earmarked for private fixed income, can staff provide the estimation/simulation on its potential contribution to the overall EA return?

Managing the reputational implications of the new investment in infrastructure debt is crucial to safeguarding the Fund's credibility. We take positive note of the staff report that reputational risks can be effectively mitigated by the current Conflict of Interest (COI) framework and the proposed investment arrangements. In particular, the adoption of external managers, passive buy-and-hold strategy and comingled fund is expected to help in allaying concerns regarding the Fund in directly using non-public information obtained from its core functions. On the COI framework, the Board's discussion of the review of the investment account in March 2018 showed that the directors were to be updated on the progress with implementing the external counsel's recommendations to strengthen the role of the Designated Officer and to further enhance the Investment Oversight Committee's processes related to the management of perceived conflicts of interest. Can staff provide an update on this? Given the potential implications on its credibility, the Fund should ensure that the external managers perform appropriate due diligence of the debt instruments and their underlying infrastructure projects. In addition, we note the likely positive externalities of the infrastructure investment in supporting the Fund's global policy agenda as well as the G20 priorities for infrastructure to be a key driver of economic prosperity, sustainable development and inclusive growth. We also welcome staff's past response in incorporating environmental, social and governance (ESG) criteria into the general investment approach. To this end, can staff comment on the progress with this approach, and the challenges faced in meeting the ESG criteria, such as in relation to achieving the targeted investment return?

A robust investment guideline/framework is key in defining the scope and objectives of investments. This ensures that all relevant risks are adequately managed whilst striving to achieve the target return. An indirect and more operationally cost-effective investment approach should be complemented with clear and robust rules that set the appropriate perimeters for the external managers to operate under. In the same vein, Management and staff should be provided with sufficient operational flexibility to efficiently implement the investment account strategy. In this regard, we support the proposed change to the IA Rules and Regulations in connection with introducing infrastructure debt in the EA.

Proper reporting arrangements should be in place for transparency and accountability purposes. The Board should be updated on the performance of the investment account, including the EA, as well as the exercise of the MD's delegated authorities, through the Annual Report to the Board. Equally important is the reporting on compliance of the investment activities with the IA Rules & Regulations and investment account strategy. This also provides an opportunity for reviewing the current investment account strategy to ensure that it remains appropriate in meeting the investment objective and target return, with associated risks being sufficiently managed.

Mr. Palei and Mr. Tolstikov submitted the following statement:

We thank staff for the informative report, with clear and comprehensive arguments in favor of introducing private fixed-income investments (PFII) in the Endowment Account (EA). This issue was discussed during the 2018 Investment Account Review, and at that time we cautiously supported such portfolio diversification, provided that a thorough assessment would show that benefits outweigh risks and costs. While we appreciate the explanation of potential benefits of PFII and mitigating factors that reduce risks, we would like to ask a few additional questions.

The introduction of the new class of assets in the Endowment Account will probably require substantial efforts. The report envisages quite complex governance system. Investments in the infrastructure debt will be carried out through a special commingled investment fund (CIF), pooling resources from the IMF and some other investors. The funds accumulated in this CIF would be managed by external institutional managers and the IMF will monitor their general performance, but not day-to-day operations. Could staff explain in more detail the principles of the PFII governance? How will the CIF be chosen – do staff have in mind some existing CIFs that the IMF will join, or are we going to create our own CIF and invite other participants? Who will be responsible for establishing the CIF's governing structures and who will monitor the performance of the CIF?

We learn from Figure 11 that compared to direct IMF investment the downsides of the CIF include "higher manager dependency" and "slightly higher fees". Could staff comment on the potential size of management fees in relation to the size of the funds under the CIF's management?

In addition, we would like to better understand potential returns from the new fixed income reallocation. According to the latest Review of the Fund's Income Position (EBS/19/16), the EA income for the financial year 2019 is estimated at SDR 259 million, while portfolio returns in U.S. dollar terms are 1.31 percent through end-January. In the current environment the real 3-percent return target for the EA is challenging to achieve, which is one of the main reasons for the introduction of the new asset class. In this regard, we would appreciate more detailed information on the performance of the Endowment Account and its components, including the US dollar amount of investments by components and their returns in US dollars and in relative terms (rate of return) in the FY 2019.

As we can infer from Figure 10 (page 16), the 5-percent reallocation to private fixed-income investments (PFII) will improve expected nominal returns of these assets by about 0.2 percentage points, from about 5 percent to about 5.2 percent. Could staff provide an estimate of the expected gains in absolute terms, taking into account the projected size of PFII resources? How does it compare to a potential increase in management fees and other costs resulting from the introduction of a new asset class?

Ms. Riach and Mr. Haydon submitted the following statement:

We thank staff for their paper. It makes a good case for staff's recommended course of action, and we support the proposed amendments to the Rules and Regulations for the Investment Account.

Mr. Sun and Ms. Zhao submitted the following statement:

We thank staff for the paper and support staff's recommendation for earmarking 5 percent allocation for private fixed income to be invested in infrastructure debt. This change offers an ideal diversification and risk-return opportunity while being operationally cost effective to implement. We also agree with the proposed amendments to the Investment Account (IA) Rules.

With attractive yield levels and relatively low correlations with the Endowment Subaccount (EA)'s existing asset classes, infrastructure debt is an appropriate sector of private debt markets to be included in the EA. The introduction of the private infrastructure debt could enhance diversification, reduce corporate credit risks, and boost the EA's return. It would also be helpful in enhancing longer-term growth and facilitating private sector and institutional investors in filling the infrastructure funding gaps.

We encourage more investments in infrastructure debt in emerging markets (EMs) given the momentum and greater potential in EMs. In the 2018 IA review, the Board approved several refinements to the EA's investment strategy, one of which was a 5 percent reallocation from EM bonds to EM equities. Could staff share more information on the progress made and future steps planned in this regard?

We see merit in staff's proposal to use an indirect approach for investments in infrastructure debt via an investment fund. We believe that indirect access through commingled funds as a first step into the private debt markets is a practical and cost-effective way and could achieve greater diversification. Meanwhile, flexibility is also needed in setting eligibility requirements and should be reflected in the new IA rules.

On currency exposure, while the proposed currency exposure approach is in line with the existing requirement, we see merit in choosing the SDR as the base currency of the EA. This would ensure consistency with the Fund's balance sheet and could provide a natural hedge against currency risks, which in turn would help preserve the real value of the EA. Staff's comments are welcome.

Mr. Rosen and Mr. Vitvitsky submitted the following statement:

We thank staff for the comprehensive feasibility study on introducing private fixed-income investments in the endowment subaccount (EA). Based on the study's results, we are prepared to support the 5.0 percent allocation for infrastructure debt in the EA. We believe this proposal provides clear benefits to the EA through greater portfolio diversification and overall performance with relatively limited downside risks.

We continue to view the EA as a pool of assets that will help provide a steady contribution to the Fund's overall income in the future. As the paper itself notes, the EA has considerable capacity to tolerate less liquid or even illiquid assets, given its long-term nature and very limited liquidity requirements. We agree, and a 5 percent allocation to infrastructure debt is still a relatively small allocation.

We also found the paper's rationale for focusing on infrastructure debt to be sound. As a growing and deepening asset class with a favorable risk-return profile, infrastructure debt appears to be an appropriate initial fixed-income exposure for the EA. We are also encouraged that infrastructure debt is less sensitive to the business cycle than traditional corporate debt and that it has demonstrated better long-term credit performance than equivalently-rated corporate debt.

At the same time, the estimated return improvements of at least 50–75 basis points (net of fees) on the 5 percent infrastructure allocation are modest. As the 2018 EA Review highlighted, meeting its 3 percent real return target over time will be challenging given prevailing and expected market conditions. In this regard, we welcome the introduction of technical briefings to the Board on the performance of the EA. It will also be important to refine the EA strategy in the future and we look forward to the next review.

Finally, we would appreciate greater clarity on the role of the MD and Investment Oversight Committee (IOC) in establishing modalities for allowing limited investments in infrastructure debt that is rated below BBB- at time of acquisition. Staff comments would be welcome.

The Acting Chair (Mr. Furusawa) made the following statement:

We begin today's agenda item on the Investment Account including the Private Fixed Income and the Endowment Subaccount. All Directors issued gray statements. The staff's background paper for today's discussion reports on the outcome of its feasibility study and follows up on the Board's March 2018 review of the Investment Account. At the time of the review, Directors endorsed the proposal for staff to explore further the potential feasibility and appropriateness of including private fixed-income investments in the endowment. Directors also called for further consultation with the Board while the study was completed.

The staff's background paper describes the conclusion of this feasibility study and includes the proposed revision to the rules and the regulations for the Investment Account. Board approval requires 70 percent majority of the total voting power.

The staff representative from the Finance Department (Mr. Brennan) made the following statement:[1]

We thank Directors for their thoughtful statements, and we welcome their broad support for the proposed refinement to the investment strategy for the endowment of including a 5 percent allocation to infrastructure debt. We have submitted a set of answers to Directors' questions in their gray statements, and I will focus my opening remarks on adding to our written responses on a few broader issues raised by Directors.

Several Directors highlighted the importance of selecting managers of the highest professional standards for investments in infrastructure debt. In this context, some Directors noted that the staff saw benefits in exploring co-investment partnerships with large insurance companies which invest clients' portfolios alongside their own. They asked whether insurance companies would be favored over traditional asset managers. We will consider traditional asset management companies in the managers selection process as well as insurance companies offering asset management services.

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

However, based on extensive discussions during the feasibility study, it became apparent that insurance companies may offer some clear advantages since their interests are well aligned with those of their investment management clients. Insurance companies have established successful track records in the management of their own investment grade infrastructure debt portfolios, and by combining their own funds with those of third-party clients, they can achieve greater scale economies and exercise greater negotiating power over loan terms, reducing costs and risks for themselves and their co-investors.

Insurance companies are first and foremost risk assessors. Their skills equip them well to consider non-financial factors—such as the risks from climate change, for example—in their investment decision making processes. For the endowment account, this represents an opportunity to leverage the internal capacity of experienced long-term investors with similar interests and strong risk management capabilities. At the same time, we would also look at infrastructure funds established by asset managers should those funds align with our investment objectives. We would only engage with managers who have a solid track record as infrastructure investors and as strong fiduciaries.

Given the degree of responsibility placed on the external managers under the proposed arrangements, we fully agree with Directors that the staff's due diligence during the selection process and oversight of retained managers will perform a key role in managing overall risks in this new asset class, including reputational risk.

As some Directors noted, investing in infrastructure raises reputational considerations through the risks that the Fund may become associated with a troubled project. It is not possible to eliminate this risk entirely, but the investment arrangements proposed by the staff will mitigate it effectively. Investing through an externally managed commingled fund will ensure that the Fund is not directly involved in selecting individual projects nor directly linked to them.

Infrastructure projects are more likely to run into difficulties that raise reputational concerns, such as the risk of corruption, during the construction phase. By focusing on financing projects in the operational phase, these risks will be reduced. Even so, problems with operating concessions can still arise post-construction. Again, the staff's due diligence during the manager selection process will consider the approaches managers follow to minimize the risk of these types of problems.

Finally, a few Directors noted that with a 5 percent allocation and a modest increase in the expected return over corporate bonds, investments in infrastructure debt will not materially increase the overall performance of the endowment subaccount. Some ask whether the allocation would be increased or the initial conservative approach relaxed after some experience, or whether further changes in the broader investment state for the endowment subaccount are envisaged.

It is important to consider the impact of this small proposed allocation to infrastructure debt in the context of the broader set of refinements to the endowment strategy approved by the Board last year. Our analysis would still indicate that the overall package of refinements should increase the returns of the endowment account by 30 to 40 basis points annually without a material increase in risk. At this point we have no plans to propose any further changes to the endowment account strategy in the immediate future.

Mr. Guerra made the following statement:

I have an additional question, and we want to thank staff for the excellent paper and for the useful outreach that they had during this process. By changing these rules, we are allowing the Fund to invest not only through the commingled funds, it can also invest directly in this infrastructure asset class, so I have a question regarding the interpretation and what we are authorizing.

In the case of direct investment of the assets, are we allowing the Fund to invest in individual assets, infrastructure assets, that are below investment grade? If that is the case, how can we interpret this limited-amount guidance that we are putting forward in the guidance on investment outside the commingled funds when we are investing in particular securities?

Mr. Saito made the following statement:

We thank the staff for the comprehensive report and the informative outreach, as well as the opening remarks.

As we pointed out in the March 2018 review of the Investment Account, given the current high valuation of the risk assets and the compressed term premium, it is reasonable to include modest allocation toless marketable investment and benefit from earning an additional illiquidity premium. Therefore, we support the proposal to invest in infrastructure debt and will give one comment for emphasis.

The feasibility study exhibits many advantages of infrastructure debt, including attractive yield, low sensitivity to the business cycle, relatively low correlation with the existing asset classes. Moreover, the simulations' results indicate the merit of diversification in that the endowment subaccount investment frontier shifts upward with the addition of infrastructure debt, even under a conservative assumption. At the same time, as the 2018 endowment subaccount review highlighted, meeting its 3 percent real return target will be challenging given the prevailing market conditions. Against this background, as Mr. Castets and Mr. Rosen alluded, more allocation to infrastructure debt or other types of private fixed-income assets would be an option to meet the 3 percent real target over time. We encourage the staff's continued analysis on possible modification to the asset allocations with accumulation of experience of investing in a new asset class.

Ms. Mannathoko made the following statement:

We have already issued a gray statement broadly supporting the decision, so I will keep my intervention short. We thank the staff for the comments they provided, and I would just like to highlight a few points. First, while we note the staff's comments, we would like to emphasize the importance of adequate attention being paid to the screening and selection of investment managers or insurance companies, as well as to the subsequent monitoring and management.

Second, we would also like to stress the importance of monitoring both issuer risks and the underlying infrastructure asset market risk. This is given the experience of the pre-global financial crisis period, when we know that some credit rating agencies misrepresented asset quality in investment-grade rated paper.

Finally, we would like to associate ourselves with Ms. Levonian, Mr. Tombini, Ms. Mahasandana, and others in requesting regular updates on the performance of the investment account, including the performance of the private fixed-income component in the endowment subaccount.

Mr. Doornbosch made the following statement:

We thank the staff for the paper, the proposal, and the helpful outreach to our office. We support the proposal to invest the 5 percent allocation earmarked for private fixed-income investment in infrastructure debt and in related amendments to the investment account rules.

We feel that the considerations for this strategy in the proposal are well explained in the paper and also further elaborated on in the answers to technical questions. I would therefore like to use this opportunity to discuss a broader issue relating to the sustainable investment criteria that are guiding the Fund's investment decisions. In our view, the Fund should fully incorporate environmental, social, and governance (ESG) criteria in its investment approach. We understand that this is given due consideration at the moment but not in a fully integrated way. We believe we can take a further step and make it a more comprehensive part of the investment strategy. In recent years, the Fund has taken a far more active stance on governance issues, on environmental issues, and also on inequality issues, and it is important that the Fund is also a role model in its own investment decisions, and so the Fund should be considered the best practice for investment managers, and we feel that we could increase our ambition in this regard.

We are pleased that the staff is considering including a discussion on ESG in the annual report for FY2019. Considering to include still leaves room to not include it, so I suppose that has to do with whether the annual report is the best vehicle to include and to entertain such a discussion. Otherwise the staff could also consider coming to the Board with a separate paper that could already include the proposal for how to strengthen the ESG criteria in the framework. That is probably a better approach, to take a step immediately in common with the proposal in the Board paper, but that does not exclude reflecting on this in the annual report.

Mr. Merk made the following statement:

We thank the staff for the insightful paper and their introductory remarks. Putting aside earlier concerns against the introduction of a new asset class, we can concur with the proposed decisions if transparency of the investment decisions and activities and timely information to the Board are ensured, and we understand that this is the case.

Preserving the real value of the endowment and therefore reaching the 3 percent target rate should have highest priority. In that context, aiming for a cost-efficient investment approach, as elaborated by the staff, is highly welcome. Furthermore, we take positive note that the proposed investment in a new asset class has the potential to generate positive external effects, which is a virtue of infrastructure debt. Nevertheless, while investing in sustainable projects in renewable energy, environment, social protection, healthcare, and education would be welcome, it needs to be acknowledged that the prime purpose of the investment in private infrastructure is to improve the portfolio and achieve higher yields for the endowment.

The staff representative from the Finance Department (Mr. Brennan), in response to questions and comments from Executive Directors, made the following statement:

Let me turn to Mr. Guerra's question first, and this is similar to a question that Mr. Merk raised in his gray statement, which is essentially that the initial proposal would be to invest through commingled funds, and we confirm that if we were to consider investing directly in infrastructure, we would first consult with the Board before making that step. As Mr. Guerra correctly points out, the rules are written in a more general fashion to permit investments, but the initial implementation approach will be solely through commingled funds, and a consultation would take place. At that time, if it were to happen, we could address the issues in terms of appropriate holdings of sub-investment grade, if that were the case.

I would turn to Mr. Doornbosch's request on ESG and highlight the fact that this year in September, the Investment Oversight Committee set the agenda for one of its quarterly meetings to cover exactly this topic of ESG issues and how they are incorporated into the investment account. We will report on the findings of that discussion in the annual report and potentially, as he suggested, go much further. The technical briefing that we have scheduled for an informal discussion around the annual report, which would just be after the August recess, would be an opportunity for Directors to share their reactions and hopefully advise us on the next steps in terms of more formally setting out a framework for incorporating ESG in the portfolio. But as he alludes, there is already on an informal basis a fairly well-established practice for how we expect our managers to take these considerations into effect in making investments on our behalf.

Mr. Alhomaly made the following statement:

We thank the staff for their answers. I just want to react to one issue on the ESG criteria. If this issue needs to be looked at, it should be looked at in the context of the overall investment policy of the portfolio, and if staff is considering to develop such standard, then the Board has to be closely engaged throughout the process and should have the opportunity to discuss different proposals before approving them. This is extremely important because there are different criteria across the globe, so it is important for the Board to be closely engaged throughout the process.

The following summing up was issued:

Executive Directors welcomed the feasibility study on introducing private fixed-income investments in the Endowment Subaccount, as a follow-up to last year's review of the Investment Account. They supported the proposal to allocate 5 percent of the passively managed portion of the Endowment assets to infrastructure debt and the proposed investment arrangements. Directors supported amending the Rules and Regulations for the Investment Account accordingly. They saw these modifications as a gradual evolution that should help achieve the Endowment's investment objective over time.

Directors considered that a limited allocation to infrastructure debt instruments could offer risk-return and diversification benefits for the Endowment. With its long-term investment horizon and limited liquidity requirements, they concurred that the Endowment has considerable capacity to tolerate less marketable instruments and could benefit from an illiquidity risk premium. Among the various sectors of the private fixed-income market, Directors agreed that infrastructure debt would offer the best diversification and improve the risk-return profile of the Endowment's portfolio, while also being cost effective to implement. They noted that the experience gained in investing in the new asset class would help inform possible modifications to the strategic asset allocation in the future.

Directors stressed the need to follow a prudent investment approach. They considered that the implementation parameters proposed by staff are broadly appropriate for the Endowment's investment in infrastructure debt. These include the use of external managers, the passive buy-and-hold approach, the primary focus on investment-grade equivalent debt, and the initial preference to invest via commingled funds. Directors acknowledged the need for certain flexibility introduced by investments through commingled fund structures. They therefore considered it appropriate to delegate to the Managing Director the responsibility for establishing certain modalities of eligibility and divestment, as well as for rebalancing the passive portion of the Endowment.

Directors underscored the importance of safeguarding the Fund's reputation and appropriately mitigating the risks of actual and perceived conflicts of interest. They agreed that the existing framework and the proposed new arrangements are adequate for addressing these concerns. They also emphasized the importance of a robust selection process for external asset managers and ongoing oversight by staff and the Investment Oversight

Committee to ensure that investments remain aligned with the Board's overall risk tolerance. Directors noted that investment in infrastructure debt has the potential to generate positive externalities. In this context, a few Directors encouraged staff to consider formalizing appropriate measures to incorporate environmental, social, and governance considerations into the management of the Fund's investments.

Directors looked forward to the next technical briefing to the Board on the performance of the Investment Account, including progress in implementing investments in private infrastructure debt, following the issuance of the Annual Report. They also encouraged timely updates to the Board as warranted by market or other developments.

APPROVAL: April 15, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Broad strategy considerations for the EA

1. ***In this respect, we would like to know if and when, beyond this strategic revision of the EA assets allocation, staff will reconsider the return target.***

- Staff maintains the view presented in the March 2018 IA Review that it is still too early to change the EA's return target. However, staff expects to reassess the return target at the next IA review (see also the response to question 8 below).

2. ***In the 2018 IA review, the Board approved several refinements to the EA's investment strategy, one of which was a 5 percent reallocation from EM bonds to EM equities. Could staff share more information on the progress made and future steps planned in this regard?***

- The reallocation from EM bonds to EM equities was completed in July 2018 during the annual rebalancing of the EA.

3. ***On currency exposure, while the proposed currency exposure approach is in line with the existing requirement, we see merit in choosing the SDR as the base currency of the EA. This would ensure consistency with the Fund's balance sheet and could provide a natural hedge against currency risks, which in turn would help preserve the real value of the EA. Staff's comments are welcome.***

- The Executive Board selected the U.S. dollar as the base currency for the EA and the Fund's GED as the deflator to align these parameters with the EA's financial objectives of supporting the Fund's administrative expenditures, which are predominantly in U.S. dollars (SM/12/317). Consistent with these decisions, the Board also approved staff's proposal to express the EA's payout rule in real U.S. dollar terms using annual GED as inflation adjustment (EBS/18/25).

4. ***Under the EA payout policy framework, the Executive Board has delayed the initiation of EA payouts until FY2021. Do staff envisage any changes to the proposed investment arrangements, should the Board decide to initiate payouts after FY2021?***

- Staff does not expect the initiation of EA payouts in FY2021 to require any changes to the proposed investment arrangements.

Risk-return considerations of the proposal

5. ***Is staff planning to review the 5 percent allocation for private fixed income in the future based on experience?***

6. ***At the same time, we would ask for confirmation that future amendments that go beyond the currently proposed approach of the investment strategy will be subject to Board consultations. This clarification appears indicated since the document refers on several occasions to "…initially focusing on infrastructure debt"/"… and with an initial limited allocation".***

7. ***Going forward, further amendments to the investment allocation could be also considered. As the feasibility study exhibits many advantages of infrastructure debt, more allocation to infrastructure debt would be an option to meet the 3 percent real return target over time given the prevailing market environment. Staff's comments are welcome.***

8. ***Does staff contemplate moving toward another class of asset or a less conservative approach on infrastructure debt in the medium-term to increase this return? if yes, could they provide information on the coming investment strategy and expected return?***

- Staff's proposal to allocate 5 percent of the EA to infrastructure debt is the last of five strategy refinements recommended in March 2018 to improve the chance for the EA to meet its investment objectives over time. At that time, Directors had recognized the challenge of meeting the 3 percent return target but agreed to maintain the target until the next IA review.

- Following this refinement to the EA strategy, staff does not anticipate proposing any further changes to the investment strategy until the next IA review. As set out in the Rules and Regulations, a review of the Investment Account and of the Fund's relevant conflict of interest policies is expected to take place every five years, with the next review expected by March 2023. At that time, the Board will have an opportunity to assess the performance of the EA and determine whether further strategy refinements are needed to meet the investment objectives over time.

- Staff can also confirm that any change in asset classes and other key parameters set out in the Rules and Regulations would be subject to Board approval, and that staff will consult with the Board if there are other changes to the approach currently proposed for infrastructure debt investments.

9. ***Could staff provide an estimate of the expected gains in absolute terms, taking into account the projected size of PFII resources? How does it compare to a potential increase in management fees and other costs resulting from the introduction of a new asset class?***

10. ***In this regard, we note the estimated return improvement of 50–75 bps net of fees on the 5 percent allocation earmarked for private fixed income, can staff provide the estimation/simulation on its potential contribution to the overall EA return?***

- Based on the proposed size of about USD 350 million for the infrastructure debt allocation and expected return of some 5.8 percent for the asset class, the expected absolute gain would be about USD 20 million on an annual basis.

- Compared with developed market corporate bonds, and assuming an excess return improvement of 75 bps on a net-of-fee basis, the expected incremental gain would be about USD 2.6 million per annum.

- These return projections are long-term in nature and are sensitive to the underlying assumptions. Investment return projections over a short-term horizon are highly uncertain.

11. ***In this regard, we would appreciate more detailed information on the performance of the Endowment Account and its components, including the U.S. dollar amount of investments by components and their returns in U.S. dollars and in relative terms (rate of return) in the FY 2019.***

- The estimated return for the EA for the full FY2019 is 4.8 percent in U.S. dollar terms, and its estimated market value is USD 7.61 billion. Audited numbers for FY2019 will be reported to the Board in the Annual Report of the Investment Account and Trust Assets.

12. ***Given the continued growth of the infrastructure debt market, as evidenced by significant investments in alternative assets by sovereign wealth funds, insurance companies, and pension funds over the past decade, could we now assume the existence of widely-accepted benchmarks for passive management of private investments, including infrastructure debt? Staff may wish to comment.***

- Private infrastructure debt has become an attractive asset class among long-term investors, but the market does not yet benefit from widely established benchmark indices to track the asset class' performance and risk characteristics. Staff's analysis relied on the actual past performance of representative private debt funds and modeled the range of possible future performance with proxies in public markets that are commonly used by private debt managers to benchmark their funds (see footnote 14, page 15). As the market develops, staff expects that benchmark indices will emerge to guide investors in their asset allocation decisions, but given the idiosyncratic nature of private debt, these indices will likely be less replicable than those for public debt.

13. ***How to manage [illiquid assets] in times of rising interest rates which might not be an unrealistic scenario for the near future and mid-term? Here, more details on the investment strategy would be welcome.***

14. ***Since investments in infrastructure debt would be managed passively according to a buy-and-hold philosophy, we would welcome staff elaboration on the targeted tenor of infrastructure debt to be included in the EA.***

- The issue of rising interest rates is a challenge for the EA across all its fixed-income investments, including in public markets. To mitigate the risk of locking in historically low-yield levels, particularly in the euro area, mandates in infrastructure debt will be broad and diversified across DM and EM countries. In addition, staff outreach indicates that some funds may be invested in floating rate loans with coupons reset periodically.

- On the tenor of the funds, staff outreach suggests a wide variety of available profiles. Some funds have shorter maturities (10–15 years) while others extend to 30 years. In addition, funds would be diversified across the maturity spectrum, reflecting phased investments and the specific characteristics of each loan. It is worth nothing that in most cases, the average life of a fund is significantly shorter than its stated maturity, given the amortizing structure of most infrastructure loans. For example, a fund with a 15-year maturity would exhibit an average life of about 10–11 years.

Broad implementation parameters

15. ***We would appreciate if staff could provide more detailed information on the fees expected in the context of the indirect approach.***

16. ***Could staff provide more specific data on the costs of management of the direct and indirect investment vehicles?***

17. ***Having said that, staff also suggests that the indirect approach incurs slightly higher fees, and thus we encourage staff's more detailed explanations on cost-benefit comparisons between two approaches.***

18. ***Could staff comment on the potential size of management fees in relation to the size of the funds under the [commingled investment fund's] management?***

- Based on outreach with managers, staff estimates the cost of investing via commingled funds (indirect approach) to be around 41 bps (comprising 31 bps management fees and 9 bps ongoing fund operating expenses and 1 bp custody safekeeping fees) compared with 37 bps for direct approach (35 bps management fees and 2 bps custody safekeeping fees). Management fees are subject to negotiation and staff could leverage existing relationships with managers for other mandates for further reductions. Staff will also explore the possibility of reducing and capping of fund operating expenses as part of manager selection and oversight.

- Though the explicit cost in terms of fees are slightly higher (by around 4 bps), as outlined in staff's paper the marginal additional cost is outweighed by the implicit benefits gained by investing via the commingled fund approach.

19. ***Although it is acknowledged that the indirect model offers better diversification potential, there is no analysis about whether minimum diversification is at all achieved in the direct model, i.e. that the direct model could not even be an alternative considering the proposed size of the allotment in infrastructure debt. Staff's comments are welcome.***

- Staff's outreach to potential asset managers concluded that greater diversification would be achieved under the commingled fund approach, given the relatively small allocation of infrastructure debt in the EA (about USD 350 million). Each commingled fund is likely to be invested across 35–50 individual projects. Assuming an allocation to two to three distinct funds to ensure sufficient manager diversification, the EA would be exposed to about 100–150 individual loans. Under the separately managed account model (SMA), given the typical minimum size of loan participation (about USD 10 million), investments would be distributed across about 35 individual loans, thereby making the portfolio more concentrated and exposed to idiosyncratic risk.

20. ***We take note that industry standards set IG-equivalent instruments representing no less than about 80 percent of the allocation and that instruments rated below IG would generally have a rating equivalent to BB- or higher. Will these limits be strictly enforced?***

21. ***We note in the proposed amendments to the IA Rules that the Managing Director may establish modalities for allowing limited investment in infrastructure debt that is rated below BBB- at time of acquisition. We would ask staff to comment on the guidelines to determine such modalities.***

22. ***Finally, we would appreciate greater clarity on the role of the MD and Investment Oversight Committee (IOC) in establishing modalities for allowing limited investments in infrastructure debt that is rated below BBB- at time of acquisition. Staff comments would be welcome.***

23. ***From the investment policy we understand that the limits pertain to the time of purchase of the assets. How are these limits be used to guide the divestment policy?***

24. ***Moreover, another issue could arise in case of a substantial under-performance of an investment project against the backdrop of the "hold-strategy" (e.g. substantial down-grading because of immense project delays or operational difficulties). Staff comments are welcome.***

- The paper argues for a focus on the least risky segment of the infrastructure debt market, namely investment-grade equivalent loans and the operating phase of an infrastructure project. For operational reasons, it is standard industry practice to allow some flexibility on instrument eligibility. Staff outreach to potential asset managers suggests that IG-equivalent funds would hold at least about 80 percent of IG-equivalent loans. Non-IG loans would typically be limited to no more than about 20 percent and have ratings usually higher than BB-. Non-IG loans would normally cover projects about to exit the construction phase and enter the operational phase, with an expectation of improved credit quality (and ratings) over time, as illustrated in the paper, Figure 8.

- A commingled fund's overall risk profile and the risk characteristics of eligible loans would be detailed in the fund's investment guidelines, along with other critical parameters, such as the investment universe, currency risk management, or diversification requirements across individual borrowers, industry sectors, and countries. Guidelines would also typically detail the broad parameters for managing risks in the portfolio, including divestment. As noted in the paper, while the divestment from individual loans will be entirely outsourced to the manager in the case of commingled funds, staff's review of guidelines and ongoing oversight of the manager will ensure that divestment serves as an effective tool for risk management. For example, based on preliminary discussions with potential managers, divestment may be used in cases of loans not performing as planned and to safeguard the overall IG-equivalent quality of the commingled fund. Given the illiquid nature of the market, the buy-and-hold approach, and intent to harvest the illiquidity premium over time, divestment is only one option to address unexpected events (see response to questions 25–26 below).

- As in the rest of the IA, the IOC (by delegation from the MD) is charged with the selection of suitable managers. For commingled funds, the IOC will pay particular attention to the adequacy of the guidelines in light of the strategic investment parameters established by the Executive Board. The IOC will also be informed by staff's in-depth due diligence of managers—prior to their selection and once approved. Special consideration will be given to the manager's track record to maintain the overall IG credit risk quality of the fund and resolve cases of underperforming investments.

25. ***At the same time, we are cognizant of the limited control of the portfolio and higher manager dependency under the commingled investments. Could staff elaborate on the safeguards available to manage the broad risk factors of the portfolio after the initial investments?***

26. ***Other risks related to currency and revenue stability, or the political and regulatory environment, will have to be addressed and mitigated. Can staff explain how the Fund, through the mandate given to the external manager, can better address and mitigate these risks?***

- As noted in the paper, since staff will have limited control over a commingled fund's guidelines, the manager/fund selection process will play a critical role to ensure funds will be managed in accordance with the approach recommended by staff. Suitable managers will need to demonstrate a well-established track record in infrastructure debt and robust risk management processes. Given the uniqueness of infrastructure, risk management is understood as covering credit risk as well as other non-financial risks such as engineering, regulatory, environmental, and governance dimensions.

- Although the selection of individual projects will be entirely outsourced to managers, they will be required to report on a regular basis on a range of factors, including portfolio composition, credit risk, diversification across sectors and countries, and the management of credit events, if applicable.

- After the initial investment, staff will ensure that managers monitor the credit quality of the loans in the portfolio. Suitable managers will need to demonstrate that they possess the necessary internal processes to provide in-depth surveillance over these loans and carry out remedial action in the event the credit quality of an asset has deteriorated. Remedial actions would include, for example, triggering covenants or requesting additional collateral. Managers would be asked to demonstrate they have independent valuation teams and dedicated teams charged with resolving underperforming investments, particularly as loans are intended to be held to maturity.

- In extreme cases, as with other IA investments, the IOC retains the right to divest from a fund that no longer performs as expected.

27. ***Finally, against the backdrop of a rather difficult selection of projects, governance and transparency of infrastructure investment compared to other assets of the portfolio so far, which criteria for the selection of investments (including reference projects and examples) are foreseen?***

28. ***Therefore, within the strategy outlined and the related mandate, would there be flexibility and diversity in terms of the regions where the investments would flow and more narrowly, would the exposure to sectors within infrastructure debt be defined?***

29. ***Could staff comment whether it is plausible to invest in infrastructure debt on all continents under the proposed investment arrangement?***

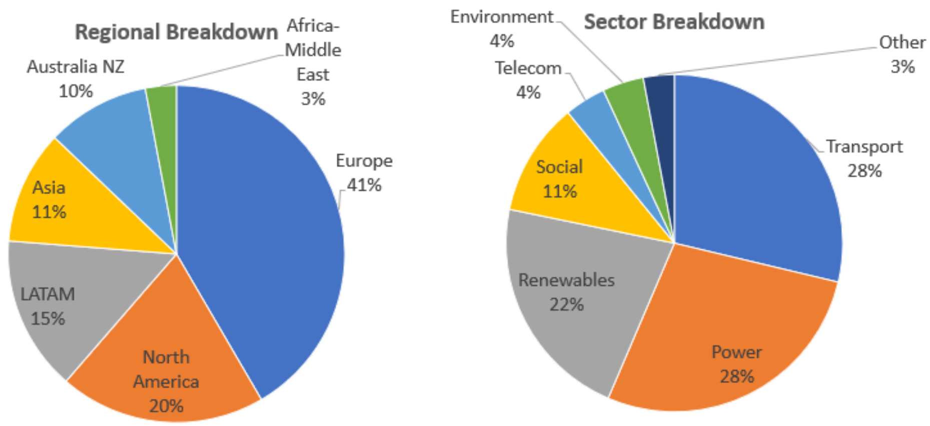
30. ***Does this mean EA infrastructure debt portfolio would include infrastructure project loans in both DM and EM markets, thereby altering the EA's strategic asset allocation (SAA) of 85 percent DM and 15 percent EM?***

31. ***Would energy sector be excluded from the private infrastructure debt in the EA? We appreciate staff comments.***

- As with other IA investments, the selection of individual loans (investments) will be entirely outsourced to external managers. Mandates will be broad and diversified across countries, industry sectors, and borrowers to ensure adequate portfolio diversification and sound risk management. Infrastructure covers a wide range of sectors, including energy, as illustrated in Figure 1.

- Under current market conditions, IG-equivalent private loans are mostly available in the Americas and in Europe across developed (DM) and emerging (EM) countries. For now, Asian markets remain dominated by banks and government financing. It is therefore expected that funds would be invested in both DM and EM countries. This implies that the aggregate allocation to EM asset classes in the passively managed portion of the Endowment Subcaccount could marginally increase from its total share of 15 percent under the current SAA as a result of the 5 percent allocation to infrastructure debt. Of note, managers in the 5 percent active portion of the EA are also permitted to invest across EM and DM as long as they remain within a 15-percentage point band around the 60/40 bond-equity allocation of the EA.

Figure 1. Global Infrastructure Project Finance by Volume (2017)



Source: Cambridge Associates

32. ***Could staff explain in more detail the principles of the PFII governance? How will the [commingled investment fund] CIF be chosen – do staff have in mind some existing CIFs that the IMF will join, or are we going to create our own CIF and invite other participants? Who will be responsible for establishing the CIF's governing structures and who will monitor the performance of the CIF?***

- As noted above (questions 25–26), commingled funds established by asset management companies will be selected by the IOC (by delegation from the MD) based on the adequacy of the manager's investment process and strategy for the prudent approach recommended for the EA's infrastructure debt investments. Amongst the wide range of possible managers surveyed in its outreach, staff identified a short list of potentially suitable managers in the IG segment of the market. They will be put forward for the IOC's consideration after further due diligence in the summer of CY2019.

- Regarding the governing structure of the funds, while the precise contours of investor involvement in private debt funds will be known only when negotiating the terms of the fund agreements, staff expects that decisions on the selection of investments and day-to-day operations, and almost all decisions on other matters would be made by a general partner or manager.

- As in other IA investments, performance will be monitored by staff with quarterly reports to the IOC. As noted in the paper, paragraph 34, staff will report to the Board on the key characteristics of infrastructure debt investments, including credit risk profile, in the Annual Report and at the informal briefing.

33. ***Could staff offer more details on the specific benefits of insurance companies and the cost comparisons of the two approaches?***

34. ***Regarding selections of asset managers, we take note that staff sees benefits in exploring partnership opportunities with large insurance companies, could staff elaborate more on advantages of such partnerships with insurance companies?***

35. ***Could staff confirm if insurance companies offering co-investment partnerships with the Fund would be selected over traditional asset management firms in externally managing the EA's 5 percent allocation to private infrastructure debt?***

- As noted above, the manager selection process will play a critical role to ensure funds are managed in accordance with the approach recommended by staff. Suitable managers will need to demonstrate a well-established track record in infrastructure debt and robust risk management processes. In this context, staff will consider insurance companies offering asset management services as well as traditional asset management companies.

- Staff will respond further on this topic during the meeting.

36. ***We invite staff's explanation on a current schedule/prospect for initiating investments in infrastructure debt.***

- As part of the feasibility study, staff met with many asset managers (and investors) to assess the suitability of different approaches. This exercise helped identify possible investment managers. Staff expect to put forward a short list of suitable managers for the IOC's initial consideration at its September meeting, in order to allow sufficient time for further due diligence. Staff expects the EA to invest in two to three distinct funds, following legal contract negotiations.

- As noted in the paper, paragraph 41, investments will be phased in as managers identify suitable opportunities. The phase-in of the infrastructure debt allocation is expected to take about two years once managers are appointed. The pace of implementation will be reflected in the Annual Report.

Conflicts of Interest (COI) and reputational considerations

37. ***Could staff elaborate more on how staff mitigate risks of COI related to IMF program countries?***

- While the perception of COI may not be eliminated, it can be mitigated with appropriately designed measures. As described in the paper and noted by Directors, the Fund's current COI framework and the proposed investment arrangements are suitably designed to effectively mitigate the COI risks. In particular, the separation of responsibilities, the Fund's COI policies and procedures and management's oversight serve as key measures against actual and perceive COI. Furthermore, other measures, including outsourcing the day-to-day management to external managers with broad mandates, the passive buy-and-hold strategy, the indirect investment through commingled funds and the relatively small share of IMF investment in any individual infrastructure project, would also limit the IMF's exposure to COI risks.

- When entering into an investment fund, staff will explore the feasibility of negotiating special terms to allow the IMF to be excused from contributing to any loans to finance projects that might present high risk of perceptions of COI, such as a government-sponsored project domiciled in a country that is with an active IMF-supported program or, as a matter of public knowledge, is discussing an IMF-supported program.

38. ***On the COI framework, the Board's discussion of the review of the investment account in March 2018 showed that the directors were to be updated on the progress with implementing the external counsel's recommendations to strengthen the role of the Designated Officer and to further enhance the Investment Oversight Committee's processes related to the management of perceived conflicts of interest. Can staff provide an update on this?***

- Staff are evaluating further steps to address the recommendations by the external counsel. The reinforcement of the role of the Designated Officer is being considered as part of the evaluation of the compliance framework for the Fund, led by the Office of Risk Management (ORM), in consultation with the Office of Internal Audit (OIA). It is necessary first to determine the universe of compliance risks the Fund may be subject to. OIA has done a report on the Fund's current compliance activities, which partially addresses this question. With respect to the enhancement of the IOC processes, staff has drafted additional procedures that will be proposed to the IOC for discussion this summer. Staff will update the Board once the work is completed.

39. ***We would caution against the likelihood of getting the Fund involved in infrastructure-related corruption cases, which are not an uncommon phenomenon across the world. We take positive note of the reassurance provided by the expected due diligence processes, as well as by the fact that investing through commingled funds makes it unlikely that the IMF would be associated with any specific project. However, it may be sensible to have a contingency plan in case of information leakages. Staff's comments are welcome.***

- Staff will discuss possible contingency plans with the Investment Oversight Committee in the event that the IMF is ever linked to a troubled infrastructure project.

- Staff will respond further on this topic during the meeting.

40. ***Sustainability should be a key concern given our responsibility as a role model in the global financial system, and we would suggest the Investment Oversight Committee to attach the highest consideration to ESG criteria. Moreover, we invite staff to include rules in this regard in the next IA Review. Staff's comments are welcome.***

41. ***We also welcome staff's past response in incorporating environmental, social and governance (ESG) criteria into the general investment approach. To this end, can staff comment on the progress with this approach, and the challenges faced in meeting the ESG criteria, such as in relation to achieving the targeted investment return?***

- In the upcoming FY2019 Annual Report, staff is considering to include a discussion on ESG, following questions by a few Directors on the role of ESG in the Fund's investments. The update will highlight the key conclusions from an in-depth ESG review conducted by the IOC, including the results of staff's assessment of how existing managers are currently incorporating ESG considerations in their investment processes. Based on Directors' feedback, staff will consider possible next steps to formalize appropriate integration of ESG considerations in the investment of the IA and TA.

Board involvement

42. ***Although we do not want to micromanage staff, we do believe that an annual report detailing the investment strategy and the portfolio performance is not enough. In this regard, we reiterate our call for the Board (or at least a committee of Executive Directors) to have access to more frequent reporting. This would certainly increase the Board's accountability regarding the investment strategy.***

43. ***We concur with staff that further delegation to the Managing Director would allow for a more efficient implementation of the IA strategy by ensuring the operational flexibility needed to efficiently rebalance a portfolio with liquid and illiquid assets. Moreover, allowing the Managing Director to establish necessary rebalancing modalities is expected to reduce transaction costs while maintaining investment strategy over time. However, we suggest that this would be complemented by a more frequent reporting procedure to the Board, as warranted by market or other developments. Staff's suggestions on how to apply this are welcome.***

- Based on Directors' request for further reporting during the 2018 IA Review, staff held a technical Board briefing on the Annual Report for FY2018 to provide Directors an additional opportunity to review and discuss portfolio and market developments. As the briefing was well received, staff intend to continue this practice after the issuance of the Annual Report for FY2019. In addition, should market or portfolio developments warrant, more frequent reporting would be provided.

- Staff will enhance reporting related to infrastructure debt investments, including key characteristics and credit profile, in the Annual Report.