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Enabling poor rural people
to overcome poverty

IFAD's Debt Sustainability Framework – Application of the modified volume approach

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For: Review

IFAD's Debt Sustainability Framework – Application of the modified volume approach

I. Introduction

1. As a major creditor, IFAD has taken a responsive and central position with regard to debt relief and debt management in Member States and has been a participant in the Debt Initiative for Heavily Indebted Poor Countries (HIPC) since its inception in 1996. As of 2010, IFAD has emerged as one of the major multilateral creditors of the Debt Initiative: out of the 23 creditors, it is now ranked seventh – after the World Bank, the International Monetary Fund, the African Development Bank, the Inter-American Development Bank, the Central American Bank for Economic Integration, and the European Union – and fifth in terms of participation in debt relief for African participants in the Initiative.
2. As an additional approach to support debt management, the Debt Sustainability Framework (DSF) has been developed to ensure that the development efforts of the poorest countries are not compromised by the re-emergence of unsustainable debt levels after HIPC relief has been given or, for non-HIPC countries, by the unsustainable growth of new debt. Accordingly, new development assistance is provided to them on terms consistent with achieving and maintaining sustainable levels of debt, and includes support for debt management at the country level. In summary, therefore, the Debt Initiative deals with the existing, historical stock of debt, whereas the DSF helps to manage future debt accumulation.
3. In 2007,¹ in accordance with the recommendation made by the Consultation on the Seventh Replenishment of IFAD's Resources and endorsed by the Governing Council, the Executive Board approved the implementation of a DSF at IFAD. In so doing, it noted that the Member States had expressed commitment "to compensate IFAD within a pay as-you-go mechanism as adopted under the fourteenth replenishment of the International Development Association". It also recommended that IFAD report annually to the Board on the timing and extent of such compensation (see below). The annex to this document contains the Board's full recommendation.
4. As part of the decision to begin implementation of a DSF, the Board, as noted in the minutes² of the session, requested that IFAD:
 - (a) Commencing in 2008, report annually to the Executive Board on the estimated principal and net service and interest charge payments forgone in the previous financial year as a result of the implementation of the DSF;
 - (b) In the context of the Consultation on the Eleventh Replenishment of IFAD's Resources (2018), prepare and present a paper on its experience and the experience of other multilateral financial institutions since their adoption of the DSF, with regard to actual and estimated net losses in service charge payments, and present proposals on future approaches to compensation as required; and
 - (c) Apply a modified volume approach involving a discount of 5 per cent of the value of DSF grants, and review these arrangements regularly, starting in three years' time, taking into account its own experience, and the experience and practices of other institutions.
5. This information paper complies with this third request to report back to the Executive Board in 2010 on the application of a modified volume approach.

¹ Proposed arrangements for implementation of a debt sustainability framework at IFAD (EB 2007/90/R.2).

² Minutes of the ninetieth session of the Executive Board (EB/90/Rev.1). See also Closing statement (EB 2007/90/INF.6).

II. The modified volume approach (MVA) and its application by other institutions.

6. The MVA was introduced by both the International Development Association (IDA) (World Bank) and the African Development Fund (ADF) (administered by the African Development Bank) as part of the DSF to marginally reduce the volume of grant financing to address the imbalance between levels of loan and grant financing and the disincentive to prudent debt management. Consequently, the implementation of the DSF at IDA and ADF involves the application of a MVA whereby the part of a country's allocation under the performance-based allocation system (PBAS) delivered in the form of a DSF grant is discounted by 20 per cent. This serves to maintain the performance linkage with the resource allocation system and to give a strong signal about, inter alia, the benefits of good public financial management. At IDA, 9 per cent of the discounted 20 per cent (of the PBAS allocations delivered in the form of grants) is placed in blended lending operations, and the remaining 11 per cent is returned for allocation through the PBAS. Both institutions continue to apply the MVA, at a level of 20 per cent, and have indicated no issues either to their respective executive boards or, informally, to IFAD.
7. At IFAD, unlike at IDA and ADF, the extent of financial assistance at country programme level is not at a level to provide meaningful signals about good debt management through the implementation of the MVA, although it is important to sustain the principle of performance that underpins the PBAS at IFAD. On the other hand, the objective of maximizing resource flows to the undersupported area of rural development and poverty reduction needs to be maintained. IFAD therefore applies a 5 per cent discount level to maintain PBAS principles but minimize the impact of the DSF on upfront flows of assistance to the poorest and often most vulnerable countries. All proceeds of the MVA discount at IFAD are reallocated to the PBAS, i.e. the 5 per cent deducted from the allocations of DSF eligible countries is redistributed to all countries in the PBAS allocation period.
8. Progress in implementing the DSF was reviewed by participating institutions at the annual Multilateral Development Bank Meeting on Debt Issues hosted by the World Bank in July 2010, at which IFAD was represented. All institutions continue to implement the DSF (and MVA) as planned. There has been further refinement of debt sustainability analyses (DSAs), which are carried out jointly by the World Bank and the International Monetary Fund, to give additional flexibility and coverage at country level. These DSAs, which form the basis of the "traffic lights" governing the application of DSF support, have been modified to include the effect of remittances and exclusion of state-owned enterprise debt. DSAs continue to be carried out every three years, subject to annual updates.

III. Impact of the 5 per cent MVA level at IFAD

9. Participating institutions acknowledge that they cannot give precise estimates of the costs of their DSF, given the impossibility of predicting the future debt sustainability status of individual countries – and the fact that the volume of future grants will be tied to the size of future programmes of work. Nevertheless, projections are made and, in 2007, scenarios were developed to assess the implications of the MVA levels on forgone principal payments together with forgone service charges, based on the indicative 2007 work programme. The agreed scenario of 5 per cent, updated with the actual programme of work for 2007-2009 and the anticipated programme of work for 2010-2012 and beyond are given in the table below.

Forgone principal repayments and service charge payments as a result of the implementation of a DSF at IFAD at MVA of 5 per cent

(Millions of United States dollars)

<i>Replenishment period</i>	<i>Forgone principal payments</i>		<i>Forgone service charge payments</i>	
	<i>MVA at 5% 2007</i>	<i>MVA at 5% 2010</i>	<i>MVA at 5% 2007</i>	<i>MVA at 5% 2010</i>
Seventh			-0.02	-0.06
Eighth			-0.28	-2.57
Ninth			-1.95	-8.43
Tenth	-3.90	-3.46	-5.48	-16.60
Eleventh	-38.77	-40.65	-10.30	-25.41

10. In addition, in line with the Executive Board request, a report is presented to the Board every April on the estimated principal and net service and interest charge payments forgone in the previous financial year as a result of the implementation of the DSF.³ The figures in the above table⁴ are reflected in the annual report to the Executive Board.

IV. Conclusion

11. The DSF, as noted at the recent Multilateral Development Bank Meeting on Debt Issues, continues to be implemented as planned, with small refinements in the DSAs. The application of the MVA by IFAD and other DSF participating institutions has, essentially, not been problematic in the implementation of the DSF. The annual reports to the IFAD Executive Board continue to reflect the effect of MVA on the estimated principal and service charge forgone, and keep Board members informed on the scale and timing of eventual pay as-you-go compensation for principal payments forgone.

³ Estimated principal and net service charge payments forgone as a result of the implementation of the Debt Sustainability Framework (EB 2010/99/R.36).

⁴ Figures for 2010 remain estimates subject to final commitments during the year.

Proposed arrangements for implementation of a debt sustainability framework at IFAD (extract from EB 2007/90/R.2)

Recommendation for approval

In the light of the recommendations of the Report of the Consultation on the Seventh Replenishment of IFAD's Resources, adopted by the IFAD Governing Council at its twenty-ninth session on 16 February 2006, and the expressed commitment of IFAD Member States, and particularly those that are major contributors of official development assistance, to compensate IFAD within a pay as-you-go mechanism as adopted under the fourteenth replenishment of the International Development Association, as well as the considerations presented in this document, it is recommended that:

- (a) IFAD immediately implement a debt sustainability framework (DSF) to govern the form of its financial assistance to countries eligible for highly concessional lending;
- (b) IFAD use the classification of countries in terms of debt sustainability as produced by the World Bank and the International Monetary Fund in their country debt sustainability analyses;
- (c) IFAD extends financial support projects and programmes governed by the performance-based allocation system (PBAS) in countries eligible for highly concessional loans on the following basis:
 - (i) For countries with low debt sustainability: 100 per cent grant
 - (ii) For countries with medium debt sustainability: 50 per cent grant and 50 per cent loan
 - (iii) For countries with high debt sustainability: 100 per cent loan;
- (d) In the context of the implementation of the DSF, IFAD apply a modified volume approach involving a discount of 5 per cent of the value of DSF grants extended. The proceeds of this discount will be reallocated to augment PBAS allocations according to PBAS allocation rules;
- (e) IFAD participate in consultations with other multilateral financial institutions on the operation of the DSF, and will propose to the Executive Board any changes in the implementation of the DSF at IFAD as and when required to maintain harmony with the practices of the International Development Association;
- (f) Commencing in 2008, IFAD report annually to the Executive Board at its April session on the estimated principal and net service and interest charge payments forgone in the previous financial year as a result of the implementation of the DSF;
- (g) In support of the implementation of the pay-as-you-go compensation mechanism associated with the IFAD replenishment process, IFAD prepare for each replenishment consultation, commencing with the Eighth, an estimate of the principal payments forgone as a result of the implementation of the DSF in the then current replenishment period; and
- (h) In the context of the Consultation on the Seventh Replenishment of IFAD's Resources, IFAD prepare and present a paper on its experience and the experience of other multilateral financial institutions since their adoption of the DSF, with regard to actual and estimated net losses in service charge payments, and present proposals on future approaches to compensation as required.