

Document: EB 2011/102/INF.10  
Date: 10 May 2011  
Distribution: Public  
Original: English

**E**



Enabling poor rural people  
to overcome poverty

## **Legal opinion concerning the ranking of the lending terms applied to IFAD financing**

### **Note to Executive Board representatives**

#### Focal points:

#### Technical questions:

**Rutzel Martha**  
General Counsel  
Tel.: +39 06 5459 2457  
e-mail: r.martha@ifad.org

#### Dispatch of documentation:

**Deirdre McGrenra**  
Governing Bodies Officer  
Tel.: +39 06 5459 2374  
e-mail: gb\_office@ifad.org

Executive Board — 102<sup>nd</sup> Session  
Rome, 10-12 May 2011

---

**For: Information**

## Legal opinion concerning the ranking of the lending terms applied to IFAD financing

### I. The issue

1. This opinion is issued further to the question raised by the representative for Japan at the 118<sup>th</sup> meeting of the Audit Committee on 3 May 2011 concerning the fact that – as stated in the 2010 consolidated financial statements (AC 2011/118/R.3) – during 2010 the interest rate applied to intermediate loans was lower than the service charge applied to highly concessional loans. During that period, the interest rate applied to intermediate loans was 0.46 per cent in the first semester and 0.55 per cent in the second semester. As per paragraph 32(a) of the Lending Policies and Criteria, throughout that period the service charge applied to highly concessional loans was three fourths (0.75) of one per cent per annum. Specifically, the question posed is whether the yearly service charge of 0.75 per cent should be considered as the minimum level for interest rates applied by the Fund to its loans.

### II. Analysis

2. According to paragraph 31 of the Lending Policies and Criteria adopted by the Governing Council, the Fund shall provide loans to developing Member States upon highly concessional, intermediate and ordinary terms for approved projects and programmes. With regard to highly concessional loans, paragraph 32(a) of the Lending Policies and Criteria prescribes that these shall be free of interest but shall bear a service charge of 0.75 per cent per annum. With respect to loans on intermediate terms, paragraph 32(b) provides that these will be subject on an annual base to an interest rate equivalent of 50 per cent of the interest rates charged on ordinary loans. Given that during 2010 this rate stood at 0.92 per cent and 1.10 per cent during the first and second semester respectively, unqualified application of the foregoing rule implied that, in 2010, the interest rate applied to intermediate loans was 0.46 per cent in the first semester and 0.55 per cent in the second semester. As a result, the cost of borrowing from the Fund during 2010 for intermediate borrowers was less than the cost of borrowing for Member States eligible for loans on highly concessional terms.
3. The foregoing situation poses the question whether, given the levels of concessionalism established by the Governing Council, the Executive Board is authorized to approve loans on intermediate terms that are more favourable than highly concessional loans.
4. To answer this question, it needs to be recalled that the system of ranking in lending terms established by the Governing Council is premised on the idea that the terms and conditions applicable for lower-income countries should reflect the highest level of concessionalism. This is important because section 7 of the By-Laws for the Conduct of the Business of IFAD clearly states that “[T]he Board shall not take any action pursuant to powers delegated to it by the Governing Council that is inconsistent with any decision of the Council.”
5. It will be recalled that paragraph 33(b) of the Lending Policies and Criteria stipulates that the Executive Board shall:
  - “decide, annually, the rates of interest to be applied, respectively, to loans on intermediate and ordinary terms. For that purpose, it shall review annually the rates of interest applicable to loans on intermediate and ordinary terms and revise such rates, if necessary, on the basis of the reference rate of interest in effect on 1 July of each year.”
6. Pursuant to this delegated authority, in September 1995, the fifty-fifth session of the Executive Board authorized the President to establish the IFAD rates of interest

for the following year without prior Board approval, but on the understanding that the Board would be notified of the rates so established.<sup>1</sup> Rates were established routinely on the basis of the July-December variable interest rates of the International Bank for Reconstruction and Development (IBRD). In 2007, the IBRD's Executive Board approved a significant simplification and reduction in IBRD loan and guarantee pricing by setting the IBRD variable interest rate based on the London Interbank Offered Rate (LIBOR). In September 2008, the Executive Board was informed that the President had approved the use of the special drawing right LIBOR 12-month composite rate as the reference interest rate in 2009 for IFAD loans on intermediate and ordinary terms, rather than the IBRD published currency pool rate – the rate that had been applied until that time. To bring IFAD rates closer to those offered by the market and the other multilateral financial institutions, acting under the above-mentioned delegation, the Executive Board decided at its ninety-seventh session (14-15 September 2009) that the periodicity of the update of the IFAD reference interest rate be revised from 12 to six months. It decided that the applicable interest rate for each six-monthly period will be based on the SDR LIBOR six-month composite rate in force on day one of the six-monthly period.<sup>2</sup>

7. By virtue of the application of this decision against the background of market developments during 2009, the situation arose as described in the introduction of this opinion. From a legal standpoint it would appear that in order to assess whether this situation is in conformity with the system of concessionality adopted by the Governing Council, the following factors need to be considered:
  - (a) Interest rates and service charges are distinct concepts that cannot be compared in all respects;
  - (b) The fact that no interest rate is charged on highly concessional loans, only a fixed service charge;
  - (c) Highly concessional loans have a longer maturity period, including a grace period of 10 years.
8. Taken together these factors lead to a situation that on balance amounts to lower borrowing costs for highly concessional borrowers, despite any temporary situation – as that occurring during 2010. It cannot be said that the Executive Board exercised its delegated authority in a matter that is inconsistent with the system of concessionality established by the Governing Council.
9. It should be noted that the eligibility criteria for intermediate loans – having a GNP per capita of between US\$806 and US\$1,305 in 1992 prices<sup>3</sup> – does not mean that these loans go to middle-income countries. The recipients of loans on intermediate terms are developing Member States with low incomes and significant need. It is therefore appropriate that the terms applicable to loans on intermediate terms be only marginally less favourable than those applicable to highly concessional loans.
10. A direct comparison between loans on highly concessional and loans on intermediate terms demonstrates that the terms for highly concessional loans are indeed more favourable than those in the intermediate category. Highly concessional loans have a maturity period of 40 years instead of 20 years. The applicable grace period is 10 years instead of 5 years. And, most importantly, the applicable service charge of 0.75 per cent is fixed throughout the 40-year life of the loan, while the intermediate interest rate is floating, and changes every six months.

<sup>1</sup> Document EB 95/55/R.45.

<sup>2</sup> Document EB 2009/97/R.46/Rev.2. For the sake of completeness it is noted that in its resolution 158/XXXIII on the Revision of the Lending Policies and Criteria, the Governing Council authorized the Executive Board to introduce hardened terms. That is of no consequence for the present analysis and will not be further discussed.

<sup>3</sup> Lending Policies and Criteria, paragraph 31(a).

11. The interest rates applied by IFAD today are at unprecedentedly low historical levels. It is almost certain that these rates will increase in the near future. Sooner or later, the rate applicable to intermediate loans will exceed 0.75 per cent, and it could go much higher. On the other hand, the Member States that borrow at highly concessional rates can make their long-term plans, secure in the knowledge that the service charge they pay will never increase.
12. As to the specific question of whether the service charge of 0.75 per cent yearly should be considered as the minimum level for interest rates applied by the Fund to its loans, it is noted that while the answer to that question is negative, the Executive Board would be free to decide as a policy matter that it would allow the interest rate applicable to intermediate loans to be less than 0.75 per cent per annum. However, such a policy decision would imply that, by virtue of paragraph 32(b) of the Lending Policies and Criteria, the minimum interest rate applicable to loans on ordinary terms would be 1.5 per cent on a yearly base.

### **III. Conclusions**

13. Based on the foregoing, the following conclusions are warranted:
  - The fact that the Governing Council decided that a service charge of 0.75 per cent per annum shall apply to loans on highly concessional terms does not imply that the interest rate applicable to loans on intermediate terms cannot under any circumstances be lower than 0.75 per cent on a yearly base.
  - Given the cumulative effect of all the elements that determine the degree of concessionality of loans (i.e. service charge, interest rate, grace period and maturity), as long as on balance the treatment received by highly concessional borrowers is more favourable than that received by borrowers on intermediate terms, then it cannot be said that the Executive Board exercised its delegated authority in a matter that is inconsistent with the system of concessionality established by the Governing Council.
  - If for policy reasons the Executive Board decides not to allow the interest rate applicable to intermediate loans to be less than 0.75 per cent per annum, this would imply that the minimum interest rate applicable to loans on ordinary terms would necessarily be 1.5 per cent on a yearly base.