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Enabling poor rural people
to overcome poverty

Procedures and definitions for determining resources available for commitment based on sustainable cash flow

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For: Information

Procedures and definitions for determining resources available for commitment based on sustainable cash flow

Executive summary

1. A major focus of the Consultation on the Ninth Replenishment of IFAD's Resources was to ensure the long-term financial soundness of the Fund by establishing projections for IFAD's resources on the basis of a sustainable cash flow approach.
2. As requested in the Report of the Consultation on the Ninth Replenishment of IFAD's Resources (GC35/L.4), the present document provides definitions and procedures for determining the resources available for commitment for IFAD's programme of loans and grants under a sustainable cash flow approach, with advance commitment authority (ACA) being a derived factor for information purposes only.

Background

3. As defined in article 4, section 1 of the Agreement Establishing IFAD, resources available for commitment are resources in freely convertible currencies that have been contributed by Member States and others; resources that have been or are to be derived from operations; or loan repayments by borrowers to the extent that these resources have not already been committed for loans and grants or appropriated for the General Reserve.
4. Under article 7, section 2(b) of the Agreement Establishing IFAD, it is the responsibility of the Executive Board to determine the proportion of the Fund's resources to be committed to operations in any financial year.
5. In past years, at each Executive Board session, loans and grants were considered for approval based on a statement of resources available for commitment. This statement served to ensure that funds were available and adequate to support the loans and grants presented for approval during the session or submitted for approval through the lapse-of-time procedure prior to the subsequent Board session.
6. Up until the end of the Eighth Replenishment period, the policy and approach for determining resources available for commitment were as follows:
 - (a) Only actual receipts in the form of cash or promissory notes were included in committable resources. The value of instruments of contribution against which payment in the form of cash or promissory notes had not yet been made were excluded from committable resources.
 - (b) Provisions were established for overdue promissory notes and committable resources decreased accordingly.
 - (c) Promissory notes and commitments for loans (undisbursed effective loans, approved loans signed but not yet effective and loans not yet signed) and undisbursed grants were recorded at nominal value within the statement of resources available for commitment, as this was an operational report for management purposes only.
 - (d) The Executive Board was authorized to employ ACA prudently, to compensate year by year for shortfalls in the resources available for commitment and to act as a reserve resource. ACA permitted IFAD to use its stable and predictable loan reflows as a basis for commitment authority.
7. The Governing Council authorized the use of ACA at its twentieth session in February 1997 by amending the Agreement Establishing IFAD to this end. The main intent of the ACA was to cover any shortfalls in the amount of committable resources available to support loans and grants that arose in a particular year due to delays in the receipt of contribution payments, volatility in the rate of return of

investment income and/or delays in the receipt of payments and repayments related to loans provided by the Fund. In 2001 (the beginning of the Sixth Replenishment period), the ACA was used for the first time and the maximum amount available through this mechanism was equal to US\$450 million (approximately equivalent to the total loan reflows expected for the subsequent three years). The maximum ACA amount was increased to equal five years of future loan reflows for the IFAD7 period, and was increased again to seven years of future loan reflows for the IFAD8 period.

8. Resolution 166/XXXV on the Ninth Replenishment of IFAD's Resources states that "Effective 1 January 2013, when the Executive Board authorizes advance commitment funds to be derived from operations pursuant to its power under article 7.2(b) of the Agreement, the Fund's commitment capacity shall be assessed and determined in accordance with the sustainable cash flow methodology by matching financial obligations (cash outflows) arising from commitments against current resources and projected cash inflows." In comparison to the practice under prior replenishments, this methodology to be applied in the IFAD9 period represents a major change in the composition and determination of committable resources.

IFAD's projected financial capacity based on the sustainable cash flow approach

9. The Consultation on the Ninth Replenishment of IFAD's Resources (IFAD9) focused on the long-term financial health of the Fund, taking the view that the level of programme of loans and grants (PoLG) for the IFAD9 period must be first and foremost "cash flow sustainable". A certain level of PoLG is defined as cash flow sustainable if, over the next 40 years, forecasting all of the inflows and outflows derived from the current and future PoLGs and related obligations, IFAD's liquidity (i.e. the balance of its cash and investments) never breaches the minimum liquidity requirement stipulated in its Liquidity Policy.¹ "One major distinction between the proposed [sustainable cash flow] approach and that employed for previous replenishments is that the maximum ACA ceiling is now a *derived* indicator, rather than an assumption of the financial model" (REPL.IX/2/R.5, p.5).
10. The rationale of the sustainable cash flow approach is supported by the IFAD financial model, which serves to forecast all cash inflows and outflows stemming from past, current and future commitments. During the IFAD9 Consultation, IFAD's financial model and assumptions were audited by external auditors who reported no errors or anomalies.
11. All major IFAD cash flow components have been analysed in IFAD's financial model based upon parameters negotiated for the Replenishment period. Specifically:
 - (a) Inflows:
 - (i) Member contributions (replenishment encashments)
 - (ii) Loan repayments (principal and interest)
 - (iii) Investment income
 - (b) Outflows:
 - (i) Disbursements for IFAD loans and grants
 - (ii) Operating expenditures
 - (iii) HIPC programme outflows
12. The IFAD9 Consultation concluded with a replenishment target of US\$1.5 billion and a PoLG of US\$3.0 billion.² Chart 1 illustrates IFAD9 inflows to finance a PoLG level

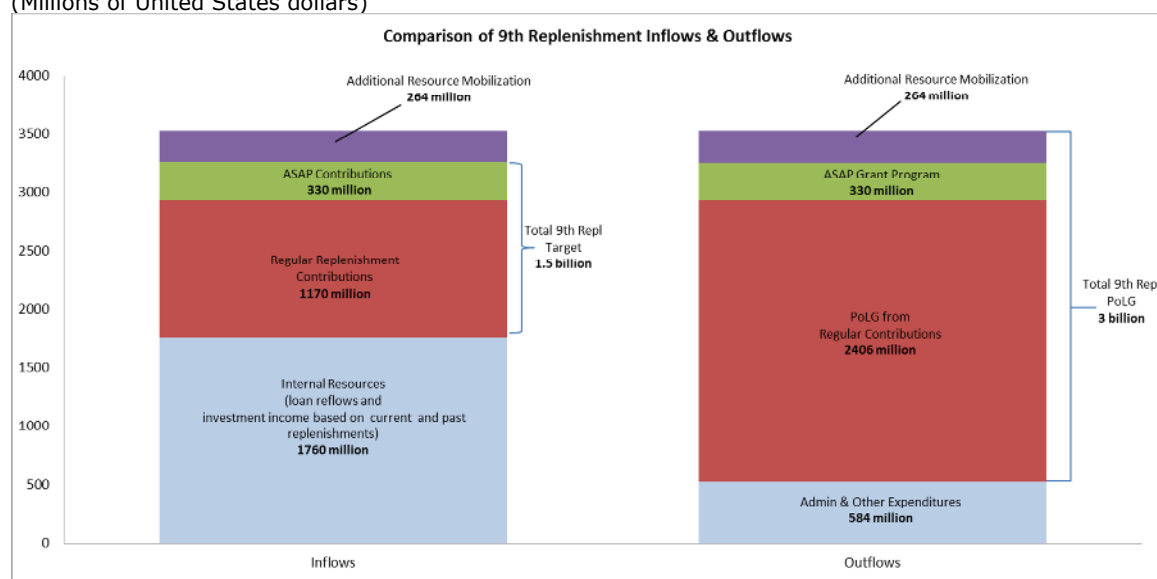
¹ EB 2006/89/R.40

² As at 31 December 2012, Adaptation for Smallholder Agriculture Programme (ASAP) pledges amounted to US\$330 million considering the Ninth Replenishment target of US\$1.5 billion; IFAD regular resources amount to US\$1.17 billion.

of US\$3.0 billion and the administrative and other expenditures needed to deliver such a PoLG. These balances are inclusive of the ASAP complementary contributions and grants to be specifically approved for this purpose. Inflows also include additional resources to be mobilized from new membership or additional financing mechanisms. For the purposes of calculating resources available for commitment, only contributions pledged are counted, although it is anticipated that additional resources will be forthcoming during the IFAD9 period in the form of contributions from new members and complementary contributions mobilized through new financing modalities.

Chart 1

Comparison of IFAD9 inflows and outflows
(Millions of United States dollars)



13. Excluding the ASAP complementary contributions and its associated grant programme, the resulting financial projections provide a representation of cash flows from regular Member contributions for IFAD9 of US\$1.17 billion and a PoLG of US\$2.4 billion. Accordingly, these projections have a time horizon of 40-50 years based upon the maturity period of IFAD's highly concessional loans.
14. The sustainable cash flow approach ensures that the net liquidity (inflows minus outflows) during this 40-50 year period will be greater than the minimum liquidity requirement. As defined in the Liquidity Policy and in order to guarantee a sustainable cash flow, IFAD should hold, in any given moment, an amount equivalent to at least 60 per cent of the total of annual gross disbursements and potential additional requirements due to liquidity shocks.
15. Under the base scenario for IFAD9 as at 19 February 2013, average gross disbursements (cash outflows) are projected to be US\$947 million per year. Potential additional cash requirements due to liquidity shocks are projected at US\$51 million. Therefore, for the IFAD9 period, the minimum liquidity requirement would equal 60 per cent of US\$998 million, or US\$599 million (see table below).

Table

Impact on IFAD's cash flow needs stemming from liquidity shocks 2013-2015

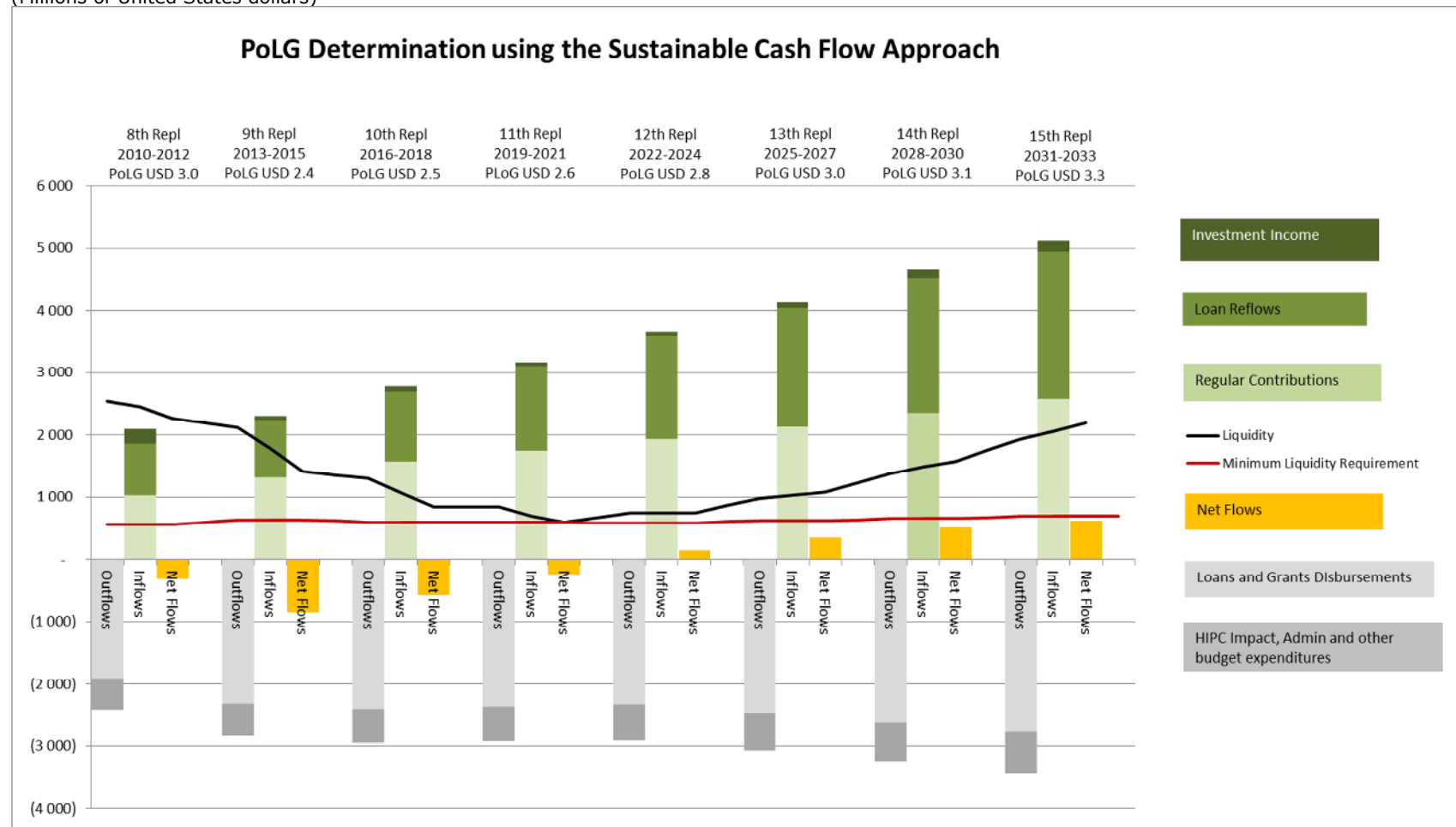
Millions of United States dollars

	<i>Amount</i>
(a) Average annual gross disbursements (cash outflows) over 2013-2015	947
Under base scenario	
(b) Potential additional requirements due to liquidity shocks:	51
Delayed encashment	28
Increased loan arrears	6
Decrease in Investment Income	17
(c) Total (a) + (b)	998
(d) Minimum Liquidity Requirement (.6 * Total)	599

16. Chart 2 (and table 1 provided in the annex) illustrates the impact of cash flows on IFAD's liquidity until IFAD15 (2033), and compares the resultant PoLG with the minimum liquidity requirement. Over the next 10 years, a decline in IFAD's internal resources is discernible as the maximum amount of liquidity (consistent with not breaching the liquidity policy threshold) is deployed into the PoLG. Subsequently, the level of liquidity rises again as the reflows exceed the rate of disbursements. If during any replenishment period, the ratio of end-of-year liquidity to projected annual gross disbursements for the same year falls below 60 per cent, then IFAD's cash flow is considered not to be sustainable. As a result, chart 2 demonstrates that the long-term financial resilience of the Fund is strong and supports the current and future projected levels of PoLG. Specifically, the minimum liquidity level resulting from the proposed PoLG is projected to be 62 per cent of disbursements for IFAD11, which does not breach the minimum liquidity requirement of 60 per cent and therefore does not affect the sustainable cash flow position of IFAD.
17. This represents an implied average advance commitment authority for 2013 of 6.9 years. Additional details pertaining to projected cash flows are provided in table 1 of the annex.

Chart 2*

IFAD cash flows and liquidity
(Millions of United States dollars)



* The key assumptions driving these figures are: a loan disbursement profile of 10 years; average loan cancellation rate of 13 per cent; administrative expenses growing at inflation after IFAD9; investment portfolio rate of return of 1 per cent for 2013-2015, 2.0 per cent for 2016, and 3.0 per cent from 2017 onwards; encashment profile of Members' replenishment contributions based on IFAD8 trend; and inflation at 2 per cent per annum.

Procedures

18. As stated in Governing Council resolution 166/XXXV, the Executive Board shall authorize commitment capacity based on a cash flow approach. Given the long-term time horizon of a sustainable cash flow approach, it is advisable that approval for the commitment authority be obtained once a year alongside approval of the PoLG in order to properly assess the long-term financial sustainability of the Fund.
19. Prior to its annual submission to the Executive Board for approval, the long-term forecast and sustainable cash flow position, including support or non-support of the anticipated level of PoLG, will be reviewed by the Audit Committee.
20. For 2013, the Audit Committee and Executive Board will receive statement of resources available for commitment based on the sustainable cash flow approach twice – at the March/April and November/December sessions.

Conclusions

21. The sustainable cash flow approach maximizes the funds available for project use; it is consistent with the Fund's Liquidity Policy; and it is aligned with the practice of other international financial institutions (the World Bank, African Development Fund and Asian Development Fund). Additionally, the approach allows for changes to underlying financial model assumptions that affect projected cash flows. As a consequence, if changing circumstances require corrective action, the sustainable cash flow approach provides a clear early warning to trigger action.

Table 1
Overall Liquidity – Balance and sustainability of cash flow as at 20 February 2013
(Millions of United States dollars)

	IFAD9			IFAD10	IFAD11	IFAD12	IFAD13	IFAD14	IFAD15
	2013 ^d	2014	2015						
Programme of loans and grants ^a	836	900	630	2 479	2 631	2 792	2 963	3 144	3 336
Liquidity at beginning of Replenishment	2 270	2 116	1 766	1 390	829	593	748	1 083	1 576
Inflows									
Loan reflows	287	297	313	1 073	1 273	1 513	1 707	1 873	1 974
Contributions ^b	435	279	295	1 210	1 337	1 475	1 610	1 748	1 895
Investment income	22	19	16	90	67	65	88	126	176
Outflows									
Disbursements	(747)	(777)	(794)	(2 384)	(2 356)	(2 325)	(2 467)	(2 620)	(2 781)
HIPC impact	0	(12)	(51)	(67)	(45)	(29)	(26)	(21)	(9)
Administrative expenses and other budgetary items	(150)	(153)	(150)	(471)	(500)	(531)	(563)	(598)	(634)
Fixed assets	(4)	(4)	(4)	(12)	(12)	(13)	(14)	(15)	(16)
PDFF	0	0	0	0	0	0	0	0	0
Liquidity at end of Replenishment	2 116	1 766	1 390	829	593	748	1 083	1 576	2 181
Liquidity vs. disbursements percentage ^c	235%	187%	139%	84%	62%	77%	104%	143%	187%

^aProgramme of Loans and Grants excludes grants related to the Adaptation for Smallholder Agriculture Programme (ASAP).

^bContributions includes encashments/drawdowns as well as cash contributions (including supplementary), excluding those for ASAP.

^cMinimum liquidity requirement defined as the minimum end-of-year liquidity position being at least 60 per cent of gross annual outflows (loan and grant disbursements, HIPC impact, administrative expenses and other budgetary items, fixed assets, and Programme Development Financing Facility (PDFF)). A percentage greater than 60 per cent indicates a sustainable cash flow period.

^dDerived advance commitment authority (ACA) for 2013 is estimated at 6.9 years.

Note: The key assumptions driving these figures are: a loan disbursement profile of 10 years; average loan cancellation rate of 13 per cent; administrative expenses growing at inflation after IFAD9; investment portfolio rate of return of 1 per cent for 2013-2015, 2.0 per cent for 2016, and 3.0 per cent from 2017 onwards; encashment profile of Members' replenishment contributions based on IFAD8 trend; inflation at 2 per cent per annum. It is assumed that DSF principal would be compensated by Member States on a pay-as-you-go basis.

The following text details the major risk factors referred to in the table in the main text.

Table 2

Liquidity shocks and related assumptions

<i>Type of liquidity shock</i>	<i>Assumption</i>
Delayed encashment of contributions	The base financial model assumes that an encashment profile where 83 per cent of funds are received within the first three years. This shock assumes 73 per cent will be received in the first three years.
Increase in loan arrears	Shock is that loan arrears will increase to 3 per cent per annum from 2013 onwards (base scenario is .02 per cent per year)
Change in investment return	The base model assumes 1 per cent investment returns from 2013-2015, 2 per cent in 2016, then 3 per cent from 2017 onward. This shock assumes a return of 0 per cent in 2013, a negative return of .5 per cent in 2014, a 1 per cent return in 2015, a 2 per cent return in 2016, and 3 per cent from 2017 onward.