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Investing in rural people

## Report on the KfW Development Bank borrowing facility

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For: Information

# Report on the KfW Development Bank borrowing facility

## I. Executive summary

1. The financing arrangement with KfW Development Bank (KfW) is a landmark transaction for IFAD that provides access for the first time to funds borrowed directly from a sovereign lender and on commercial terms for onlending by IFAD. The loan represents a source of funding for the Ninth Replenishment of IFAD's Resources (IFAD9).
2. Two individual loan agreements (ILAs), as provided for by the Framework Agreement with KfW for the granting of individual loans to IFAD,<sup>1</sup> have been signed for a combined amount of EUR 300 million. The loan has supported the resource gap that was identified to fulfil a programme of loans and grants (PoLG) of US\$3 billion for IFAD9. The funds are being used exclusively to finance IFAD projects on ordinary terms.
3. The funds are being onlent in euros, the same currency of the loan, to meet one of the conditions set by the Executive Board when approving the facility: to avoid any risk stemming from currency mismatch. Financial ratios for this loan facility have been very sound and demonstrate prudent financial management. As at 30 June 2015 all ratios were well within the thresholds established by the KfW Framework Agreement as well as within the thresholds dictated by the Sovereign Borrowing Framework.<sup>2</sup>
4. In the interest of transparency and to avoid commingling the KfW borrowed funds with IFAD's existing portfolio, Management decided to establish a new investment portfolio, the asset liability portfolio (ALP). This portfolio would be dedicated to the management of the KfW borrowed funds and any other funds that IFAD borrows in the future.
5. In terms of the investment approach, Management decided that the investment strategy best suited to the KfW funds was one centred on asset liability matching (ALM), within the context of the Investment Policy Statement (IPS).
6. In line with the investment approach as well as to meet International Financial Reporting Standards (IFRS), the portfolio has been classified as fair value through profit and loss (formerly known as marked-to-market).
7. While reviewing the implementation of this facility, Management identified three areas for further improvement moving forward; (i) conducting ex ante cost comparisons to ensure that the loan was fully reflective of IFAD's credit and matched the opportunities and conditions on the market for a loan of such magnitude; (ii) adequate currency management. Since IFAD cannot at present engage in cross-currency swaps, this restricted the choice of currency to IFAD borrowers; and (iii) challenges posed by current IFAD policies and guidelines, which, for prudence and to limit IFAD's exposure to adverse or excessive risks, dictated that IFAD give prominence to government bonds in its investments.
8. Overall, handling of the KfW funds has been smoothly and efficiently integrated into IFAD's operational framework and many positive experiences and developments can be singled out from this initiative, for example: Management has demonstrated that there is capacity in IFAD to enter into a successful, concrete partnership with a sovereign lender and to manage borrowed funds; it clearly demonstrated that borrowing can be a viable option to provide financing to meet a target PoLG; and following this initiative, the Executive Board encouraged Management to establish a general framework for borrowing, resulting in the approval of the Sovereign

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<sup>1</sup> EB 2014/112/R.14.

<sup>2</sup> EB 2015/114/R.17/Rev.1.

Borrowing Framework to guide borrowing from sovereign states and state-supported institutions.

9. Management will analyse the option of accessing the balance of EUR 100 million of the KfW facility in 2016 in order to provide financing in IFAD10 to respond to demand from borrowing Member States, subject to prior Executive Board approval.

## II. Background

10. At its 112<sup>th</sup> session on 17-18 September 2014, the Executive Board approved a Framework Agreement with KfW for the granting of individual loans to IFAD.<sup>3</sup> Subsequently, the KfW loan for EUR 400 million was negotiated under the Framework Agreement and signed on 24 November 2014 by the President of IFAD, at KfW headquarters in Frankfurt, Germany. The loan represented a source of funding for IFAD9.
11. The first Individual Loan Agreement (ILA), as provided for by the Framework Agreement, was signed on the same date in Frankfurt by the President of IFAD. The amount of that ILA was EUR 100 million.
12. The second ILA, as provided for by the Framework Agreement, was signed on 10 September 2015 by the Vice-President of IFAD at IFAD headquarters. The amount of that ILA was EUR 200 million.
13. These steps represent the culmination of a process that had started during the replenishment process for IFAD9 under the Additional Resource Mobilization (ARM) initiative.
14. This financing arrangement is a landmark transaction for IFAD that provides access for the first time to funds borrowed directly and on commercial terms for onlending by IFAD.

## III. Access to the facility

15. As reported above, the first ILA of EUR 100 million has been fully disbursed by KfW. In order to align the cash flow generated by the borrowed funds with disbursements of onlent funds, the second ILA of EUR 200 million will be disbursed by KfW in four equal tranches of EUR 50 million, on the following disbursement dates: 28 December 2015, 30 June 2016, 28 December 2016 and 30 June 2017. As at 28 December 2015, the total amount disbursed to IFAD under the Framework Agreement will be EUR 150 million.
16. Management will analyse the option of accessing the balance of EUR 100 million from the KfW facility in 2016 in order to provide financing in IFAD10 to respond to demand from borrowing Member States, subject to prior Executive Board approval.

## IV. Usage of funds

17. At the time the facility was negotiated, Management informed the Executive Board that, given the terms of the loan, and in order to mitigate interest rate risks (risk of paying interest on borrowing at an higher rate than the interest on the onlent funds), the funds would be used exclusively to finance IFAD projects on ordinary terms. This would ensure that the interest and other fees paid to KfW as well as the provisioning for defaults are covered by a combination of reflows to IFAD, generated by the onlending of the borrowed funds and income generated by investment of the undisbursed borrowed funds. In this way the facility would be self-sustainable and would not generate a need for financial support from IFAD's own resources.

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<sup>3</sup> EB 2014/112/R.14.

18. Another important condition set by the Executive Board was that the KfW funds would be onlent in euros, the same currency of the loan, in order to avoid any risk stemming from currency mismatch.
19. The KfW loan has supported the resource gap that was identified to fulfil a PoLG of US\$3 billion for IFAD9. In August 2012 the resource gap was calculated at approximately US\$528 million, equivalent to EUR 400 million. As at September 2015 this gap had been reduced to US\$262 million due to several factors including: higher than forecasted contributions from Member States, better investment income and revised disbursement flows. As a consequence, only EUR 300 million of the loan facility will be required to support the IFAD9 PoLG. All projects that will be supported by the borrowing will be for loans on ordinary terms and in euros (see paragraph 22(b)(i) and (ii)).

## V. Management of borrowed funds

20. IFAD has given careful consideration to the management of the borrowed KfW funds pending disbursement of its onlending, not least because the Sovereign Borrowing Framework<sup>4</sup> was approved in April 2015 at the 115<sup>th</sup> session of the Executive Board. The management of future borrowed funds will benefit from experience and lessons learned from the KfW facility. A number of critical points were highlighted as follows:
  - (a) The Framework Agreement with KfW for the granting of individual loans to IFAD<sup>5</sup> illustrates that the KfW facility in isolation is always cash positive – “self-funding”.
  - (b) In order to be more transparent to stakeholders, it would be advisable, for reporting purposes, not to comingle the KfW borrowed funds with IFAD’s existing portfolio. This would ensure that developments affecting KfW resources could be clearly singled out;
  - (c) In order for the loan to meet the requirements mentioned in (a) above, it may be necessary for KfW resources to be invested with a slightly different approach relative to the rest of IFAD’s portfolio.
21. The above considerations led Management to establish a new investment portfolio, the ALP. This portfolio is dedicated to the management of the KfW borrowed funds and any other funds that IFAD borrows in the future.
22. The construction of the portfolio required some additional key decisions as follows:
  - (a) Investment approach
    - (i) Management decided that the investment strategy best suited to these funds was one centred on asset liability matching (ALM), within the context of the IPS. Rather than strategies such as total return, absolute return and others normally employed by contribution-funded institutions like IFAD, ALM strategies seek to closely align assets to liabilities, and are more common with international financial institutions (IFIs). For the ALP, this meant that Management sought to invest in instruments that were as close as possible to the liability in terms of maturity and credit exposure, while yielding similar or better interest than that due to the lender. This has presented some challenges for Management. These are dealt with in the next paragraph and in section VI.
    - (ii) Given the points highlighted in paragraph 20 above, Management started to invest the funds in April 2015. In order to comply with the ALM investment approach, Management sought to invest the funds away from the traditional instruments of choice for IFAD. At the time the

<sup>4</sup> EB 2015/114/R.17/Rev.1.

<sup>5</sup> EB 2014/112/R.14, paragraph 14.

funds were invested, government bond yields were at an historical low globally: the average yield in the month of April 2015 on five-year French government bonds was only 0.024 per cent, while the same measure on German government bonds was negative 0.112 per cent. This compared with a cost of the KfW facility at the time of roughly 0.34 per cent (Euribor plus spread).

- (iii) Therefore, Management decided to seek, within the IPS and applicable guidelines, alternative investments that could better implement an ALM approach. In the weeks following April, a number of floating rate notes were added to the portfolio that better replicated the exposure on the KfW loan. Floating rate notes are not commonly issued by governments and highly rated corporate bonds were bought instead. This carried the added benefit of (a) diversifying the portfolio and (b) allowing the portfolio to invest in shorter maturities, typically two to four years, given the higher interest paid by corporate relative to sovereign issuers.
- (iv) At the time of writing this report, the ALP is comprised of about 40 per cent corporate bonds and 37 per cent government bonds, while the remainder is kept in cash to fund expected disbursements. In terms of rating, more than 50 per cent of the portfolio is invested in securities rated AA- or above.

(b) Accounting treatment

- (i) In line with the investment style reported above and in line with International Financial Reporting Standards (IFRS), the portfolio has been classified as fair value through profit and loss (formerly known as marked-to-market), according to which both realized and unrealized security gains and losses are included in the investment results and are reported in the period in which they arise.
- (ii) These funds will be clearly separated from other IFAD portfolios in all reports submitted to the Executive Board.
- (iii) A ledger has been created, fully dedicated to KfW funding, to be consolidated and audited as part of IFAD's financial statements.
- (iv) A new bank account has been opened that will receive and disburse KfW related funds.

Portfolio performance

- 23. The year-to-date (31 August 2015) performance of the portfolio is down 1.16 per cent. Most of the negative performance is attributable to the "safest" assets in the portfolio, i.e. the government bonds that Management had to buy in order to comply with the investment guidelines (more on this in section IV). However, it is important to note that this performance should not be a source of concern as it reflects the marked-to-market representation of the portfolio if IFAD needed to liquidate the entire portfolio immediately. This situation clearly will not arise and the portfolio is performing as intended, i.e. producing the income necessary to pay for the loan while at the same time keeping some resources in cash to fund projected disbursements. By the end of the year, it is projected that the portfolio will have accrued positive interest income to cover the interest payments due to KfW.
- 24. Over time Management expects the ALP portfolio to continue to maintain this positive dynamic performance, while also absorbing part of the negative marked-to-market performance.

Cash management

- 25. Handling of the KfW funds has been smoothly and efficiently integrated into IFAD's operational framework.

26. Commercial banks that have long-standing relationships with IFAD have granted unique terms and conditions on the KfW operational account, which for the past 10 months have included positive interest rates on the account cash balance, despite a market environment of negative overnight rates for the euro.
27. With regard to operations, in the period February to September 2015, KfW cash transactions generated an increase of 5 per cent with respect to the total yearly transaction volume of cash management operations. This increase is particularly significant in terms of investment settlement, operational risk and resources, and has been efficiently absorbed and integrated into IFAD's back office operations.

## VI. Lessons learned

28. The KfW transaction has offered IFAD a great opportunity to enhance both its external relevance as an IFI that is evolving and its internal capabilities, the latter through learning by doing.
29. Many positive experiences and developments can be singled out from this initiative, for example: Management has demonstrated that there is capacity in IFAD to enter into a successful, concrete partnership with a sovereign lender and to manage borrowed funds; it clearly demonstrated that borrowing can be a viable option to provide financing to meet a target PoLG; and, following this initiative, Management was encouraged by the Executive Board to establish a general framework for borrowing which resulted in the approval of the Sovereign Borrowing Framework to guide borrowing from sovereign states and state-supported institutions.
30. As with all new initiatives undertaken by an organization, in hindsight, there are inevitably aspects that could have been dealt with differently or issues that could have been addressed better or more effectively. Management has identified three:
  - (a) Cost comparison
    - (i) The KfW borrowing arrangement was a totally new initiative. Management, therefore, had no benchmark or comparison available to determine whether the cost of the loan negotiated with KfW was fully reflective of IFAD's credit. The only previous borrowing experience was that of the Spanish Food Security Cofinancing Facility Trust Fund (Spanish Trust Fund). However, because of the legal structure of the Spanish Trust Fund (creation of a separate legal entity) and government intervention to cover the costs, the two facilities are not immediately comparable.
    - (ii) In future, IFAD would benefit from conducting exploratory dialogue with more potential borrowers in order to ascertain what the market opportunities and conditions are for a loan of that magnitude.
  - (b) Currency management
    - (i) At the time of signing the KfW loan, IFAD only engaged in macro currency hedging, i.e. making sure that its overall financial resources are kept in the same currency composition of its commitments. IFAD did not – and does not – engage in micro hedging, i.e. fully matching of currency on its individual strings of cash flows. This caused IFAD to adopt the significant risk-mitigating measure of onlending the KfW funds in the same currency in which they were borrowed (in this case, the euro).

- (ii) Onlending in the same currency as the borrowed funds may prove to be a significant constraint in future IFAD operations. Management is addressing this issue through a number of steps, in particular: (a) a request will be put forward to the Executive Board in December 2015 to approve the use of cross-currency swaps; and (b) negotiations are ongoing between IFAD and bank counterparts to draft the necessary legal documentation to support execution of cross-currency swaps. This will enable IFAD to manage lending operations better, regardless of the currency in which the borrowed funds are sourced.
- (c) Challenges posed by current policies and guidelines
  - (i) As a United Nations agency and an IFI, IFAD prudently avails itself of detailed and stringent investment policies and guidelines. These are designed to prevent the institution from facing adverse or excessive risks. However, current macroeconomic and financial environment developments are testing the limits of many assumptions that were held as conventional wisdom for investments. One of these concerns the risk-free status accorded to government bonds.
  - (ii) Similar to its peer organizations, IFAD accords risk-free status to government bonds and has always operated by this principle. As a consequence, a prominent role is given to government bonds in its investments. This was reflected in the guidelines for the ALP, which implied that a large part of investments had to be made in government bonds. While this principle is still valid for many of the portfolios managed by IFAD, an effective investment of the funds under the ALP was not possible given the above-mentioned constraints. This is reflected by the fact that the negative marked-to-market valuation of the portfolio is caused predominantly by the only two investments in government bonds that the portfolio had to execute in order to comply with the guidelines. Management is seeking to prevent this from happening again in the future through appropriate fine-tuning of the investment guidelines.

## VII. Financial reporting

31. Since the inception of the KfW facility, financial ratios have been very sound and demonstrate prudent financial management. As reported in the table below, as at 30 June 2015 all ratios are well within the thresholds established by the KfW Framework Agreement and are within the thresholds dictated by the Sovereign Borrowing Framework.

Table  
**Financial ratios as at 30 June 2015**

<i>Covenant</i>	<i>Formula</i>	<i>Ratio %</i>	<i>Thresholds (financial ratios) to be complied with by the borrower</i>
<b>1. Equity ratio*</b>	(Total contributions + General reserve)/Total assets	91.1	Shall not be lower than 60 per cent
<b>2. Debt coverage ratio</b>	Total debt service (principal and interest)/total loan reflows, <b>or</b> the ratio of (i) principal and interest to all IFAD lenders in any given year to (ii) total yearly loan reflows from IFAD borrowers as per latest audited financial statements	0.1	Shall not be higher than 50 per cent
<b>3. Liquidity ratio</b>	(Cash in hand and in banks+ investments)/total assets	20.0	Shall not be lower than 5 per cent

\* Equity ratio is an equivalent measure to the debt/equity ratio as defined in the Sovereign Borrowing Framework (total principal outstanding/total contributions + General Reserve). At the end of June it was 1.4 per cent, well under the threshold of 35 per cent.