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# IFAD’s variable interest rate methodology: Impact of negative interest rates

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For: Approval

## Recommendation for approval

The Executive Board is invited to approve the following decision:

To modify the methodology for setting IFAD's variable interest rates applicable for loans approved on variable terms detailed in EB 2009/98/R.14 and EB 2011/102/R.11. The modification will allow the introduction of a zero floor to the LIBOR/EURIBOR components of IFAD's reference rate and will apply to existing and newly approved loans on the above-mentioned terms. This modification will take effect as of 1 January 2017.

# IFAD's variable interest rate methodology: Impact of negative interest rates

## I. Background

1. Article 7, Section 2(a) and (b), of the Agreement Establishing IFAD establishes the principles of long-term viability and continuity of the Fund, also indicating that the Fund shall provide financing on the terms it deems necessary.

2. Article V, Section 5.01(b), of the General Conditions for Agricultural Development Financing (General Conditions) states that "Interest and service charge shall accrue on the outstanding principal amount of the Loan and shall be computed on the basis of a 360-day year of twelve (12) 30-day months. The Fund shall provide the Borrower with a statement of interest and/or service charge due generated on the billing due dates specified in the Financing Agreement and the Borrower shall effect payment within thirty (30) days of such date."

3. Section 5.01(d) stipulates further that "During the grace period, interest and/or service charge shall accrue on the outstanding principal amount of the Loan and shall be payable semi-annually on the billing due dates, but no payments of principal shall be due." Section 5.02(a) of the General Conditions states that "The Borrower shall repay the aggregate principal amount of the loan withdrawn from the loan account" and, in section 5.02(b), "The Borrower shall have the right to prepay all or any part of the principal amount … provided that the Borrower pays all accrued unpaid interest and/or service charges."

4. Article IV, Section 15(a)(iv), of the Policies and Criteria for IFAD Financing reads:

   The Executive Board shall:

   (1) Determine, on the basis of the variable ordinary interest rate of international financial institutions [IFIs] concerned with development, the reference rate of interest for application in IFAD, which shall provide the basis for the review and revision prescribed in sub-paragraph (2) below.

   (2) Decide, annually, the rates of interest to be applied to loans on ordinary terms. For that purpose, it shall review annually the rates of interest applicable to loans on 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.

5. Based on the above, the interest rates applicable for loans approved on variable terms are calculated in accordance with the method approved by the September 2009 session of the Executive Board in an information note titled "IFAD's lending

terms and conditions: Interest rate for the year 2010 for loans on ordinary and intermediate terms" (EB 2009/98/R.14).[1] In summary, the lending terms included:

(a) That the periodicity of the update of the IFAD reference interest rate be amended from 12 months to 6 months on the basis that IFAD is moving into line with practices currently applied by other international financial institutions;

(b) That the applicable rate will be based on the SDR [special drawing rights] LIBOR six-month composite rate, with due regard to IFAD's unique mandate;

...

IFAD will determine its reference interest rate by applying a composite spread directly derived from the IBRD [International Bank for Reconstruction and Development] variable spread for the four SDR currencies to the six-month composite SDR LIBOR rate.

6. Moreover, it was agreed at the May 2011 session of the Executive Board (EB 2011/102/R.11)[2] that the IFAD reference interest rate applicable for loans approved on ordinary and intermediate variable euro-denominated terms, starting from the second semester 2011, will be the Euro Interbank Offered Rate (EURIBOR rate) plus the IBRD euro spread.

# II. Issue

7. In the light of current market conditions and the need to mitigate financial risk to IFAD's resources, as well as to be in line with indications received from other IFIs, the purpose of this paper is to clarify the existing implied minimum rate as zero for IFAD's reference rate (a 'zero floor'), applicable to loans approved on variable terms, by introducing a modification to the methodology for setting IFAD's variable interest rates to reflect this minimum floor.

8. For the first semester of 2016, there was an unprecedented occurrence in IFAD's interest rate history in which the EURIBOR and Japanese yen LIBOR components of the interest rate calculation were both negative values. However, as a result of applying IFAD's agreed methodology, which includes the application of the IBRD variable spread, the overall variable interest rates applicable to both SDR- and euro-denominated loans remained positive values.

9. IFAD's basic documents do not currently contain an express provision defining the zero floor that protects IFAD against negative rates. Based on the terms of the General Conditions, which only provides for the borrower's payment obligations to IFAD, including payment of interest rates, and not from IFAD to the borrower, it is implied that the zero floor has been accepted by IFAD and its borrowers. As noted above, short-term rates in the euro area have turned negative since the inception of the KfW Development Bank (KfW) loan facility, including the EURIBOR rate, which serves as a parameter for setting the interest rate on the KfW loan. Consequently, the materialization of these negative reference rates is resulting in IFAD incurring financial losses solely in relation to borrowed funds.

10. Albeit in clear contravention to the intention of IFAD and its borrowers when entering into financing agreements – and to the spirit of the Agreement Establishing IFAD and of the General Conditions – if market interest rates worsen so that the LIBOR/EURIBOR rates are more negative than the IBRD spread, borrowers could speculate that they have a right to claim the payment of interest

[1] "IFAD's lending terms and conditions: interest rate for the year 2010 for loans on ordinary and intermediate terms" (EB 2009/98/R.14) http://intradev:8015/gbdocs/eb/98/e/EB-2009-98-R-14.pdf.
[2] "IFAD lending terms and conditions – Applicable euro interest rate" (EB 2011/102/R.11) www.ifad.org/gbdocs/eb/102/e/EB-2011-102-R-11.pdf.

by IFAD. In the event of a discussion in that regard, although there is a strong basis for IFAD to support its zero floor, the absence of a clarification in IFAD's basic documents could generate uncertainty with regard to the impact of negative interest-rate calculations on IFAD loans.

11. In order to avoid that situation, a financial framework is needed that clarifies the original intention of the zero floor in all IFAD lending, regardless of the funding source, so to ensure a sound financial risk-mitigation mechanism that will also embed preventive measures for interest rate risk.

12. As requested by the Policy and Criteria for IFAD Financing, IFAD has sought the experience of other IFIs and received responses from the Nordic Investment Bank, European Bank for Reconstruction and Development, European Investment Bank, African Development Bank and World Bank on how they are approaching the issue of a negative EURIBOR rate. All institutions have indicated that they are considering an approach that supports the prudent management of financial resources. Specifically, the World Bank, African Development Bank and European Bank for Reconstruction and Development have indicated support for a zero floor.

# III. Recommendation

13. It is recommended that the Executive Board approve the following decision:

To modify the methodology for setting IFAD's variable interest rates applicable to loans approved on variable terms detailed in EB 2009/98/R.14 and EB 2011/102/R.11. The modification will allow the introduction of a zero floor to the LIBOR/EURIBOR components of IFAD's reference rate and will apply to existing and newly approved loans on the above-mentioned terms. This modification will take effect as of 1 January 2017.