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Investing in rural people

Proposal to access the KfW borrowing facility for IFAD10

Note to Executive Board representatives

Focal points:

Technical questions:

Michel Mordasini
Vice-President and Interim Head
Financial Operations Department
Tel.: +39 06 5459 2518
e-mail: m.mordasini@ifad.org

Domenico Nardelli
Director and Treasurer
Treasury Services Division
Tel.: +39 06 5459 2251
e-mail: d.nardelli@ifad.org

Sylvie Martin
Officer-in-Charge
Office of the General Counsel
Tel.: +39 06 5459 2474
e-mail: s.martin@ifad.org

Luis Jiménez-McInnis
Director
Partnership and Resource Mobilization Office
Tel.: +39 06 5459 2705
e-mail: l.jimenez-mcinnis@ifad.org

Dispatch of documentation:

William Skinner
Chief
Governing Bodies Office
Tel.: +39 06 5459 2974
e-mail: gb_office@ifad.org

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For: Approval

Recommendation for approval

The Executive Board is invited to grant approval for IFAD to access the remaining funds of EUR 100 million under the current KfW Framework Agreement and use the funds to deliver the IFAD10 target programme of loans and grants of US\$3.2 billion. The Executive Board is also invited to approve that IFAD enter into Individual Loan Agreements as foreseen therein.

Proposal to access the KfW borrowing facility for IFAD10

I. Executive summary

1. At its 112th session in September 2014, the Executive Board approved the recommendation included in the document "Framework Agreement with KfW Development Bank for the granting of individual loans to IFAD"¹ (KfW Framework Agreement), that "IFAD Management enter into a Framework Agreement with KfW Development Bank for the granting of individual loans to IFAD up to an aggregate principal amount of EUR 400 million." The Executive Board also approved that "Management enter into the Individual Loan Agreements foreseen therein, provided that each such individual loan is financially sustainable, as defined in the current document."
2. As stated in paragraph 4 of the above-mentioned document, the KfW loan was intended to "respond to the demand from borrowing Member States during the IFAD9 period by providing financing to meet the target of US\$3 billion for its programme of loans and grants (PoLG)."
3. The period of the Ninth Replenishment of IFAD's Resources (IFAD9) ended with a PoLG of US\$3.1 billion. To reach that PoLG, IFAD accessed a total of EUR 300 million under the KfW Framework Agreement. The Framework Agreement is not associated with a specific IFAD replenishment and allows IFAD to access the remaining EUR 100 million until 2018.
4. This document requests the Executive Board to grant approval for IFAD to access the remaining EUR 100 million under the current KfW Framework Agreement and use the funds to deliver the IFAD10 target PoLG of US\$3.2 billion. The funds will be onlent to Member States borrowing on ordinary terms.

II. Background

5. During IFAD9, IFAD entered into a Framework Agreement with KfW Development Bank under which a loan for EUR 400 million was negotiated. The borrowed funds were to be used towards the delivery of the target PoLG for IFAD9 of US\$3 billion, although the KfW Framework Agreement itself is not associated with a specific IFAD replenishment. The Framework Agreement with KfW and the first Individual Loan Agreement (ILA) were signed on 24 November 2014.
6. The Executive Board subsequently approved the Sovereign Borrowing Framework: Borrowing from Sovereign States and State-Supported Institutions² to guide all future sovereign borrowing. Therefore, the Sovereign Borrowing Framework does not apply to the KfW Framework Agreement and its related Individual Loan Agreements. Nonetheless, current financial projections show that borrowing under the KfW Framework Agreement respects all the conditions and covenants of the Sovereign Borrowing Framework, as explained below.

¹ EB 2014/112/R.14 and EB 2014/112/R.14/Add.1.

² EB 2015/114/R.17/Rev.1.

7. During the IFAD9 period, a cumulative amount of EUR 300 million was accessed by IFAD under the KfW borrowing facility through two ILAs. Disbursement of the second of these loans began in December 2015 and disbursement will be complete in June 2017. As a consequence, EUR 100 million is still available under the KfW Framework Agreement.

III. Contribution of Germany to IFAD10

8. KfW is a development bank fully owned by the Federal Republic of Germany. Germany's contributions to IFAD under the last two replenishment cycles were as follows:
 - (i) IFAD9: EUR 52,389,000 as a core contribution; and
 - (ii) IFAD10: EUR 52,220,754 as a core contribution; EUR 168,246 for the Debt Sustainability Framework; and EUR 13,000,000 as an unrestricted complementary contribution for mainstreaming climate change.

IV. Proposal to access the remaining funds under the KfW borrowing facility

9. Management proposes to sign an ILA for the remaining EUR 100 million to contribute to the delivery of the PoLG for IFAD10. Details of the proposal are provided below.

A. Analysis of the proposal

10. In terms of main features, the borrowing under the new ILA would be similar to that of the previous two ILAs:

Currency of denomination: euro

Maturity: 20 years

Grace period: 5 years

Interest rate: 6-month Euribor + spread

The ILA can be disbursed to IFAD in one or more installments as decided by the signing parties.

B. Use of borrowed funds

11. The funds will be borrowed on terms that are in line with the previous ILAs and will therefore be used to finance loans on ordinary terms. Based on a minimum PoLG of US\$3.2 billion, and the most recent projections by the Programme Management Department, there is ample demand for ordinary loans to absorb the amount borrowed. The allocations as determined by IFAD's performance-based allocation system (PBAS) will not be affected by the borrowing.
12. In line with paragraph 17 of the Sovereign Borrowing Framework (SBF) document, the borrowed funds will be used "in accordance with the Policies and Criteria for IFAD Financing". This means that the borrowed funds will be onlent at the current rate for IFAD ordinary loans and no change to that rate is envisaged as a result of the different funding source.
13. Based on the spread applied to the loan and the current projections on investment returns and reflows generated by the funds, the model shows that the loan is sustainable on a stand-alone basis in line with the principle of "financial sustainability in isolation" as required by the SBF document (paragraph 16). This concept is illustrated in the graph in the annex. The graph represents the cash flows of the facility in isolation (cash inflows, cash outflows and net flows as well as end-of-year liquidity). As per the definition in the SBF document (paragraph 16), the cash flow projections are such that the "net cash balance is never negative in the period of borrowing or onlending, whichever comes later".

14. Since the borrowed funds will be used to finance a level of PoLG decided as an outcome of the IFAD10 Consultation, the cash flow projections do not include incremental administrative costs.

C. Financial ratios

15. The financial covenants that must be respected for IFAD to enter into a borrowing agreement are defined in section IV and annex II of the SBF document. Borrowing an additional EUR 100 million during the IFAD10 period would not breach any of these covenants, as explained below.
16. After the addition of EUR 100 million in borrowing to the balance sheet, IFAD's highest level of debt to equity ratio is projected to increase from 3.7 per cent to 5.0 per cent, comfortably below the maximum 35 per cent limit established in the SBF.
17. The lowest level of the liquidity ratio is projected to increase from 7.1 to 7.5 per cent during the IFAD12 period, because of the upfront liquidity increase from the new borrowing. This ratio remains above the minimum 5 per cent threshold established for the SBF.
18. The debt service coverage ratio is projected to increase from 6 to 7.1 per cent, remaining comfortably below the 50 per cent threshold established for the SBF.

D. Evaluation of risks

19. Currency risk is the main risk that IFAD could be exposed to if the funds were onlent in a currency other than the euro. As per the SBF document (section VIII), IFAD will eliminate this risk by ensuring that the funds are onlent in the same currency as the loan, i.e. the euro.
20. As described in the SBF document, IFAD is in the process of building capacity, obtaining the necessary legal agreements and ensuring that the operational and functional steps are in place to enter into cross-currency derivatives to hedge the currency risk. This will, in the future, enable IFAD to onlend the funds in a different currency while being protected from currency fluctuations. The costs of such hedging transactions will be incorporated into projections to ensure that the self-sustainability clause is always respected.
21. Term risk, interest rate risk and liquidity risk are mitigated as per section VIII of the SBF document. The cash flow projections have been updated with the latest actual 2015 data and assumptions have been validated with all relevant departments to ensure that the paramount clause of self-sustainability in isolation is respected.

E. Management of borrowed funds

22. As described in the Report on the KfW Development Bank borrowing facility, presented to the 116th session of the Executive Board,³ in the interest of transparency and considering the different return target on the borrowed funds, Management established a new investment portfolio, the Asset Liability Portfolio (ALP). This portfolio is dedicated to the management of the borrowed funds and follows a marked-to-market strategy. The funds are kept in euro so as to avoid currency risk pending disbursements. The additional EUR 100 million will be included in the ALP.

³ EB 2015/116/R.24.

Cash flow projections of the KfW facility
 Borrowing and onlending of EUR 400 million

