

Document: EB 2016/118/R.30
Agenda: 14(e)
Date: 18 August 2016
Distribution: Public
Original: English

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Investing in rural people

Review of IFAD's Sovereign Borrowing Framework for Borrowing from Sovereign States and State-Supported Institutions

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Executive Board — 118th Session
Rome, 21-22 September 2016

For: Information

Summary

1. At its 114th session on 22-23 April 2015, the Executive Board approved the IFAD Sovereign Borrowing Framework (SBF).¹ As stated in paragraph 7 of the SBF: "This Sovereign Borrowing Framework will be reviewed initially in 2016, and the findings will be presented in a report to the Executive Board in September 2016. Subsequent reviews will be undertaken at least once per replenishment period or more often ... and if deemed necessary by Management. Each review will cover all aspects of the Framework's implementation, including experience gained in exploring and negotiating various borrowing opportunities."
2. In line with the commitment to the Executive Board, this document provides a review of the SBF. At this point in time – the start of the Tenth Replenishment of IFAD's Resources (IFAD10), and with IFAD's current financial architecture and funding sources – this review does not include any recommendations for further improvement.
3. It is worth noting that although IFAD has yet to conclude a sovereign loan under the SBF, it nonetheless provides the essential structure and parameters for ongoing discussions with potential sovereign lenders. IFAD has established a borrowing range for IFAD10 that will allow it to fill a projected financing gap and deliver a programme of loans and grants (PoLG) of at least US\$3.2 billion. This is the context for the ongoing discussions with potential lenders.
4. In addition, although the KfW Development Bank (KfW) loan facility was approved by the Board prior to the SBF, all the financial covenants of the SBF are being monitored and are respected in the implementation of the KfW facility, as reported to the Executive Board at its 116th session and updated in annex I of this document. Based on lessons learned from implementation of the KfW facility, IFAD is strengthening its in-house capacity to effectively manage forthcoming loans under the SBF.

I. The context for the Sovereign Borrowing Framework

A. Need for IFAD to borrow resources

5. The need to borrow resources in order to ensure that IFAD has implemented its target PoLG first arose during IFAD9. To this end, IFAD Management successfully concluded a bilateral agreement with KfW for a loan of up to EUR 400 million.
6. At its 112th session on 17-18 September 2014, the Executive Board gave its approval for IFAD Management to enter into a framework agreement with KfW for individual loans to IFAD of up to an aggregate principal amount of EUR 400 million.² Subsequently, KfW and IFAD signed the framework agreement. The first individual loan agreement came into effect on 24 November 2014 and the second on 10 September 2015. The loans represented a source of funding for IFAD9, with EUR 300 million of the EUR 400 million facility drawn down to support the IFAD9 PoLG.
7. During this period, the Executive Board encouraged IFAD to establish a framework to guide borrowing activities and instructed the Audit Committee to oversee the development of the borrowing framework. These efforts led to the approval of the SBF by the Executive Board at its 114th session (see footnote 1).
8. IFAD had already gained some experience in managing borrowed resources with the establishment of the Spanish Food Security Cofinancing Facility Trust Fund (Spanish Trust Fund) in 2010.

¹ Sovereign Borrowing Framework: Borrowing from Sovereign States and State-Supported Institutions (EB 2015/114/R.17/Rev.1).

² EB 2014/112/R.14 + EB 2014/112/R.14/Add.1.

B. Implementation of the SBF

9. It was planned that the SBF would enter into force during the IFAD10 period, beginning in January 2016. To date, no borrowing agreements have been concluded by IFAD under the SBF, although several exploratory talks are ongoing with potential lenders.
10. In the meantime, IFAD has begun to strengthen the finance and treasury infrastructure required to support the introduction of borrowing as an additional source of financing for IFAD. The work has involved:
 - (a) Changes to the investment guidelines (December 2015);
 - (b) The conclusion of negotiations on IFAD's first International Swaps and Derivatives Association (ISDA) Master Agreement for the execution of currency derivatives;
 - (c) Improvements in IFAD's financial model;
 - (d) Staff training; and
 - (e) Reporting on financial ratios to provide indicators of IFAD's financial situation (see annex 1).
11. Although new loans have yet to be concluded under the SBF, IFAD's experience thus far can be assessed through other proxy financing arrangements such as the funds borrowed from KfW³ and the Spanish Trust Fund.
12. As noted earlier, these two financing arrangements were not covered by the SBF since they had been negotiated prior to the approval of the SBF. However, all the conditions of the KfW financing arrangement comply with the SBF. Most of the arguments presented in this paper are based on the experience gained with the KfW financing agreement.
13. The experience with the KfW borrowing facility has been a strong learning platform for IFAD and has been instrumental in accumulating experience for Management and staff with regard to managing borrowed funds. The lessons learned and challenges encountered with the KfW facility – which were reported to the Executive Board in December 2015 (see footnote 3) – are all still valid. They have given IFAD valuable experience to improve its effectiveness in leveraging IFAD's balance sheet through the SBF.

II. Lessons learned as the SBF starts to guide IFAD's approach to borrowing

A. Creation of a high-level task force on borrowing

14. The experience with both the creation of the SBF and the signing of individual loan agreements with KfW have highlighted the importance of strong and continuous communication within the Fund's departments, which are affected by IFAD's evolving financial and operational structure. It is essential that the departments responsible for funding sources and those in contact with the clients who use the funds share the same goals, strategy, expected outcomes and outputs.
15. For this reason, in February 2016 IFAD established a high-level task force to lead the implementation of the SBF. The task force is composed of: the Associate Vice-President, Chief Financial Officer and Chief Controller, Financial Operations Department (as Chair); the Associate Vice-President, Programme Management Department; the General Counsel, Office of the General Counsel; the Director and Treasurer, Treasury Services Division; and the Director, Partnership and Resource Mobilization Office.

³ Management has reported to the Executive Board on the KfW borrowing facility, see EB 2015/116/R.24.

16. Task force members work jointly to seek borrowing opportunities that respond to IFAD's operational needs and financial terms and conditions acceptable to the Fund. The task force meets at least once per month and drives the implementation of the SBF. It also provides guidance to the departments involved in the evaluation of borrowing proposals.

B. Currency management

17. Currency management remains an important issue for IFAD – even more so in the context of borrowed resources. As reported in the update on the KfW facility, at the time of signing the KfW loan, IFAD was only engaged in macro-currency hedging, i.e. making sure that its overall financial resources are kept in the same currency composition as its commitments. IFAD did not – and still does not – engage in micro-hedging, i.e. full matching of currency on individual streams of cash flows. This lack of capacity was mitigated by adopting the significant risk-control measure of on-lending the KfW funds in the same currency in which they were borrowed (the euro).
18. IFAD is working to establish in-house capacity to engage in cross-currency swaps. Once this capacity is fully developed, it will allow IFAD to potentially swap the currency exposure of borrowed funds to match the currency requested by clients. The costs of the swap transaction will have to be embedded in the calculation of the facility's financial sustainability and reported when the borrowing proposal is submitted to the Executive Board for approval.

C. Risk management

19. Once IFAD starts to provide loans financed by borrowed resources, the issue of asset liability matching will be of utmost importance. This means that IFAD must pay close attention to aligning the interest rates charged on borrowed resources with those charged when on-lending these funds.
20. For the KfW borrowing arrangement, adequate asset liability matching was effected through several measures. On the currency side, IFAD ensured that funds would be on-lent in the same currency as they were borrowed. On the interest rate side, measures were taken to ensure that the spread applied to on-lent funds was at least equal to that charged by KfW. And on the repayment side, actions were taken to ensure that the final maturity and grace period of the KfW loan were longer than those applied to IFAD's on-lent funds.
21. However, short term interest rates in the euro area have turned negative since the inception of the KfW loan facility, including the Euro Interbank Offered Rate (Euribor), which serves as a parameter for setting the interest rate on the KfW loan. This is exposing IFAD to an interest rate risk because IFAD's financing agreements – unlike the KfW loan contract – do not contain a legal provision for an interest rate "floor" protecting IFAD from negative rates. IFAD is developing measures to mitigate this risk and a related proposal will soon be submitted to the Executive Board for approval.

III. Emerging issues in the SBF

22. As discussions and negotiations proceed with potential sovereign lenders, it is becoming clear that a number of important issues will need to be addressed in the future.
 - Size of loans. Each sovereign loan negotiated with a potential lender will have to cover a number of important issues such as financial terms and legal provisions. Since these negotiations are time-consuming, it is advisable that Management avoid excessive fragmentation of borrowing arrangements. This may pose challenges because predicting the amount of borrowing needed at any given time can prove difficult. For example, at the time of the KfW facility's negotiation (IFAD9), the financing gap was estimated at

EUR 400 million, whereas only EUR 300 million was ultimately needed to meet IFAD's PoLG target.

- Currency. The financing currency denomination is linked to the currency of the lender, but as discussed in paragraph 18 above, IFAD is aiming to increase its flexibility in this respect by introducing cross-currency swaps.
- Restrictions. Some lenders may wish to put thematic restrictions on the use of borrowed resources – for example, by limiting them to climate-related activities. Since the borrowed resources are used to finance IFAD's PoLG, such restrictions cannot be accepted by IFAD.
- Substitution. Some Member States may view loans provided to IFAD as substitutes for core contributions to IFAD's replenishment. However, the SBF provides clear guidelines in this regard: IFAD will only enter into borrowing discussions with a Member State, or a state-supported institution, if the Member State's core contribution to the latest replenishment is at least equal to the amount contributed in the previous replenishment⁴ cycle. These rules may require further clarification and elaboration as IFAD begins to implement the SBF and issues are raised by Member States regarding these rules.

IV. Conclusions

23. The SBF is proving to be a valuable instrument for IFAD by providing clear guidelines for the management of borrowed funds as the Fund engages in discussions with potential sovereign lenders for additional loans. The SBF allows IFAD to raise resources – by leveraging its strong balance sheet – to fill financing gaps and ensure that IFAD meets its PoLG targets.
24. At this time, Management is not proposing any changes to the SBF. Nonetheless, to best serve IFAD, the SBF will need to be a flexible tool attuned to IFAD's evolving needs. Should IFAD's borrowing experience indicate the need for improvements, proposed changes will be incorporated into subsequent reviews of the SBF for the Board's consideration.

⁴ An exception is made if a Member State's core replenishment contribution in the preceding replenishment is 10 per cent higher than in the replenishment before that. In such a case, the Member State's core replenishment should be at least equal not to the preceding replenishment but to the one before that.

Financial ratios under the Sovereign Borrowing Framework (SBF) as of 31 December 2015

<i>Ratio</i>	<i>Formula</i>	<i>IFAD's ratios</i>	<i>SBF ratios</i>
Debt/Equity	Total outstanding debt/total contributions + General Reserve	2.0%	<35%
Liquidity	(Cash in hand and in banks + investments)/total assets	17.8%	>5%
Debt coverage	Total debt service (principal and interest)/total loan reflows or the ratio of: (i) principal and interest to all IFAD lenders in any given year to (ii) total yearly loan re-flows from IFAD borrowers as per the latest audited financial statements	0.1%	<50%