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Investing in rural people

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

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Abbreviations and acronyms

AFD	Agence Française de Développement
ALP	Asset Liability Portfolio
EMC	Executive Management Committee
GLP	Global Liquidity Portfolio
ILA	individual loan agreement
KfW	KfW Development Bank
PoLG	Programme of Loans and Grants
SBF	Sovereign Borrowing Framework
STF	Spanish Trust Fund
TRE	Treasury Services Division

Executive summary

1. In line with paragraph 7 of the Sovereign Borrowing Framework (SBF),¹ this review follows the first review exercise, conducted in 2016, and its findings presented to the Executive Board at its 118th session in September 2016.²
2. Although no changes were proposed in the 2016 review, Management noted that the SBF should be a flexible tool attuned to the evolving needs of IFAD's financial architecture. Management also specified that, should IFAD's borrowing experience and strategy indicate the need for improvements, proposed changes would be incorporated into subsequent reviews of the SBF and submitted for the consideration of the Executive Board.
3. Building on lessons learned under the KfW Development Bank (KfW) framework agreement, which was signed prior to the SBF, the first sovereign loan agreement under the SBF was concluded in 2017 with Agence Française de Développement (AFD). Thus Management deemed it appropriate to present a review of the SBF to the Executive Board in 2017 as well.
4. The main conclusions that emerge from the present review are the following:
 - (a) IFAD is benefiting from the experience and knowledge accumulated with the SBF to strengthen its in-house capacity by efficiently managing borrowed resources, implementing rigorous asset liability matching principles and deploying capital efficiently.
 - (b) However, implementation of agreements under the SBF continues to present some challenges for IFAD – such as determining the optimal size of loans, borrowing in a currency for which there is sufficient onlending demand and borrowing at a rate that is sustainable and most favourable to IFAD.
 - (c) Other forms of borrowing such as concessional partner loans or market borrowing may be able to address these challenges. These forms of borrowing will, however, require that a new borrowing framework be created to govern such agreements.

I. Loans negotiated by IFAD under the SBF

KfW framework agreement³

5. The KfW framework agreement was signed in November 2014, before the approval of the SBF. The agreement is composed of three individual loan agreements (ILAs) of EUR 100 million, EUR 200 million and EUR 100 million respectively.
6. The first two ILAs were signed in 2014 and 2015 and were directed at financing part of the Ninth Replenishment of IFAD's Resources (IFAD9) programme of loans and grants (PoLG). The third ILA was signed in 2016 and was used to support the IFAD10 PoLG. While each ILA was compliant with the covenants of the SBF, only the third ILA was signed after SBF approval and entry into force.
7. As of 31 December 2016, only the first ILA and a portion of the second ILA had been drawn down. It is projected that the balance of the second ILA and the full third ILA will be drawn down in 2017.

¹ See EB 2015/114/R.17/Rev.1: "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." – 114th session of the Executive Board, 22-23 April 2015.

² EB 2016/118/R.30 – Review of IFAD's Sovereign Borrowing Framework for Borrowing from Sovereign States and State-Supported Institutions.

³ See EB 2014/112/R.14 + EB 2014/112/R.14/Add.1 – Framework agreement with KfW Development Bank for the granting of individual loans to IFAD.

Agence Française de Développement (AFD)

8. During 2016, IFAD entered into negotiations with another state-supported institution, Agence Française de Développement (AFD). Negotiations were concluded in 2017 with the signing of a loan of EUR 200 million to fund part of the IFAD10 PoLG.⁴
9. The first drawdown of EUR 50 million from this facility is expected on 28 December 2017. Further drawdowns of EUR 50 million are projected to occur semi-annually, with the final tranche in June 2019.

II. Lessons learned and actions taken

A. High-level task force on borrowing

10. As noted in the first review paper, in February 2016 IFAD established a high-level task force to lead implementation of the SBF.
11. Task force members work jointly to seek borrowing opportunities that respond to IFAD's operational needs and on financial terms and conditions acceptable to the Fund. The task force meets at least once per month and drives implementation of the SBF. It also provides guidance to the departments involved in the evaluation of borrowing proposals.
12. The task force serves as a preparatory body for the borrowing proposals, which are then presented to the Executive Management Committee (EMC) for further approval before they are submitted to the Executive Board.

B. Relationship with donors

13. Establishment and implementation of the SBF have been instrumental in fostering and deepening IFAD's already strong ties with its donors.
14. Execution of the negotiated agreements, exploration of possible loan proposals, and negotiation of new deals have created the opportunity for close, continuous relationships between IFAD, its donors and executing agencies. These have occurred also at the technical level and have led to considerable exchange of knowledge and expertise, ranging from legal to financial and risk management issues. This process has been very beneficial in strengthening IFAD's internal capabilities.

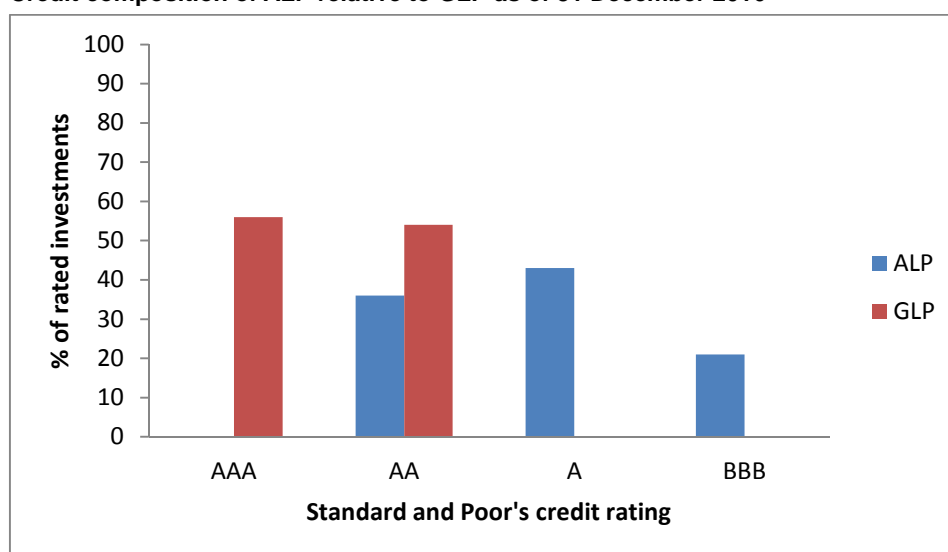
C. Investment of borrowed funds

15. To ensure transparency and segregation from IFAD core resources, in line with the requests of the Executive Board, Management established the asset liability portfolio (ALP), where all proceeds of borrowed resources are directed pending disbursements to fund the related projects.
16. The ALP is managed internally by the Treasury Services Division and is accounted for on a marked-to-market basis. It follows a strict asset liability management strategy in which the funds are invested in assets that replicate as closely as possible the interest rate, maturity and disbursement profile of the borrowed funds. This asset liability matching principle minimizes the risk of financial losses due to liquidation of assets for disbursement needs.
17. As with the previously established Spanish Food Security Cofinancing Facility Trust Fund (Spanish Trust Fund) facility, funds in the ALP have been managed with a return objective different from that of the rest of the liquidity pool managed by IFAD. In the case of borrowed funds, the investment strategy has been designed to take into account the cost of borrowed funds. Thus the portfolio's target return has been defined as a rate equal to the average interest charged to IFAD.

⁴ See EB 2016/119/R.38.

18. Because the portfolio is one of the largest individual portfolios at IFAD, managing it internally has produced two significant benefits:
- **Cost savings**
Had the funds been allocated to external asset managers, IFAD would have incurred additional expenses in management fees of approximately US\$150,000 in 2015, US\$250,000 in 2016, and US\$400,000 in 2017. As the size of borrowed funds is expected to increase, so too will the expected savings.
 - **Internal capacity-building**
The internal management of borrowed resources has led to more-frequent intradivisional and interdepartmental cooperation within IFAD. In particular, the Treasury Services Division (TRE), Accounting and Controller's Division, Financial Management Services Division and the Programme Management Department collaborate closely to estimate future disbursement needs more accurately. Within TRE, rigorous asset liability matching principles were adopted in actively managing these funds. In addition, in response to the increased trade volume stemming from active management of the portfolio, more efficient trade settlement processes were developed.
These tasks were carried out under the supervision of and in close collaboration with the risk and compliance function. More interaction among the different teams has led not only to operational synergies, but also to knowledge transfer and internal capacity-building.
19. Despite the protracted distortions in the euro market, where interest rates have remained persistently low or even negative, the ALP returned 2.3 per cent in 2016, relative to an average interest charged to IFAD of 0.2 per cent. Thus, through internal fund management, IFAD has been able to generate a return on borrowed funds that is greater than the cost of borrowing.
20. However, in order to generate these returns, and given the low and negative yields in the euro market, investments were diversified across the credit quality spectrum permitted by IFAD's Investment Policy Statement. The credit composition of the ALP differs significantly from that of the internally managed global liquidity portfolio (GLP), as shown in the graph.

Graph 1
Credit composition of ALP relative to GLP as of 31 December 2016



21. The additional EUR 200 million from the AFD loan will be included in the ALP. However, should IFAD access further borrowed resources in the future in currencies

other than euro, a second asset liability portfolio would be created so as to keep the portfolio “currency matched” and to ensure adequate control of currency risks.

D. Risk management

22. For the KfW borrowing arrangement, adequate asset liability matching was effected through a number of measures:

- **Currency risk**
Pending implementation of derivatives and a verification of the associated costs, IFAD ensures that funds are lent in the same currency in which they were borrowed. Management is also engaged in exploring opportunities to borrow funds denominated in currencies in which the greatest demand for IFAD loans is anticipated. This would ensure that currency risks are reduced to the minimum.
- **Interest rate risk**
Measures were taken to ensure that the spread applied to lent funds was at least equal to that charged by KfW. In addition, following a critical issue highlighted in paragraph 21⁵ of the first review paper, a further measure was adopted to ensure a proper asset liability matching approach. An interest rate floor at zero was introduced and applied to the EURIBOR reference rate component of the IFAD interest rate charged to ordinary borrowers. This fully matches the corresponding provision in both the KfW and AFD loan contracts.
- **Cash flow sustainability risk**
Actions were taken to ensure that the final maturity and grace period of the KfW loan are longer than those applied to IFAD’s funds lent on ordinary terms. This was done to ensure that the ALP remains cash flow sustainable in isolation.
- **Liquidity risk**
In managing these funds, TRE ensures a proper balance between keeping the borrowed funds invested for return purposes and maintaining enough liquidity to fund upcoming disbursement needs. For this reason, the actual disbursement rate of IFAD loans funded from borrowed resources is carefully monitored to promptly identify any divergence from the projected disbursement rate and adjust liquidity accordingly.
- **Credit risk**
In consideration of the credit composition of the ALP, shown in the graph above, constant monitoring from the credit perspective of the funds managed is performed by TRE in conjunction with the risk and compliance function. Credit exposure to the various asset classes is continuously monitored, particularly for those investments at single A rating or below. In addition, measures have been introduced to further mitigate credit risk exposure. Cash balances in operational accounts are now significantly lower, and adequate liquidity for timely disbursements is ensured by fine-tuning liquidity management and cash flow forecasting.

III. Remaining issues in the SBF

23. As IFAD gains experience in negotiating and managing sovereign borrowing arrangements, it is clear that the important issues identified in the first SBF review will still need to be addressed in the future.

- **Size**
Each sovereign loan negotiated with a potential lender includes a number of

⁵ 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 exposed IFAD to interest rate risk because IFAD’s financing agreements – unlike the KfW loan contract – did not contain a legal provision for an interest rate “floor” to protect IFAD from negative rates.

critical financial terms and legal provisions that must be carefully analysed to validate their suitability to IFAD. Consequently, negotiations require significant effort and time, and it is thus 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 borrowing need was estimated at EUR 400 million, whereas only EUR 300 million was ultimately needed to meet the IFAD9 PoLG target.

- **Currency**
The financing currency denomination is linked to the currency of the lender, but as discussed in paragraph 21 above, IFAD is aiming to increase its flexibility in this respect by introducing cross-currency swaps.
- **Restrictions**
The SBF allows sovereign lenders to propose thematic restrictions on the use of borrowed resources. In each case, Management will evaluate the proposed restrictions and provide the Executive Board with its assessment as part of the approval process. It should be noted, however, that certain restrictions may be difficult to accommodate, as borrowed resources are used to finance IFAD's PoLG.⁶
- **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 replenishment cycle. This provision may require further elaboration as IFAD's experience in sovereign borrowing strengthens and evolves.
- **Cost**
While IFAD has been able to secure the KfW and AFD loan facilities on favourable terms, the cost of these loans should be compared with that of other forms of borrowing. Funding through either concessional partner loans or market borrowing could perhaps be obtained at more favourable interest rates.

IV. Conclusions

24. Management is not proposing any changes to the SBF at this point in time. The clear guidance on management of borrowed funds provided by the SBF continues to be a valuable tool for IFAD as the Fund engages in discussions with potential sovereign lenders for additional loans.
25. However, despite the guidance of the SBF and the significant progress IFAD has made in managing borrowed resources, sovereign borrowing continues to present significant challenges for the Fund. Consequently, IFAD is exploring additional borrowing alternatives.
26. Other forms of borrowing such as market borrowing or concessional partner loans may be able to address these challenges. As IFAD proceeds to explore additional borrowing channels, a new comprehensive approach to borrowing will be developed that will replace the Sovereign Borrowing Framework.

⁶ See EB 2015/114/R.17/Rev.1 – Sovereign Borrowing Framework: Borrowing from Sovereign States and State-Supported Institutions.

Financial ratios under the Sovereign Borrowing Framework (SBF) as of 31 December 2016

<i>Ratio</i>	<i>Formula</i>	<i>IFAD's ratios</i>	<i>SBF ratios</i>
Debt/equity	Total outstanding debt/total contributions + General Reserve	3.3%	<35%
Liquidity	(Cash in hand and in banks + investments)/total assets	15.9%	>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 reflows from IFAD borrowers as per the latest audited financial statements	0.1%	<50%