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# Management Response to the Corporate-level Evaluation on IFAD's Financial Architecture

Note to Executive Board representatives

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# Management Response to the Corporate-level Evaluation on IFAD’s Financial Architecture

## I. Introduction

1. Management welcomes the final report on the corporate-level evaluation (CLE) of IFAD’s financial architecture, and commends the Independent Office of Evaluation of IFAD (IOE) for the thorough analysis. The evaluation is timely as Management is working towards enhancing the Fund’s financial model for the Eleventh Replenishment of IFAD’s Resources (IFAD11) period and beyond. The evaluation has therefore provided Management with useful insights for a corporate reflection on the way forward on a topic that is central to IFAD’s business model.

2. Management would like to express appreciation for IOE’s constructive collaboration throughout the evaluation exercise, in particular by providing IFAD Management and staff with the opportunity to share their inputs, data and documentation on the topic. Management particularly appreciates the self-assessment workshop, organized jointly with IOE, as a key step in the evaluation process to stimulate dialogue and learning.

3. The final evaluation report provides a useful analysis of the opportunities and challenges that IFAD needs to consider in connection with its financial model moving forward. Given IFAD’s hybrid nature as a United Nations specialized agency, fund and international financial institution (IFI), the report appropriately reflects on the link between its loan portfolio, resource allocation mechanism, pricing of loans, leverage, Debt Sustainability Framework (DSF) mechanism, types of products and instruments, and margins for cost recovery.

4. At the same time, Management believes the final evaluation report could have been more thoroughly anchored within the context of the far-reaching institutional reforms and transformation currently under way. The business model and financial architecture are being enhanced in numerous ways to make IFAD fit for purpose to deliver on its mandate of promoting sustainable and inclusive rural transformation. For example, the commitment under IFAD11 to introduce a coherent transition framework to govern engagement with borrowing Member States, and within that framework new financial instruments such as results-based lending and regional lending, are some of the areas that will have implications for IFAD’s financial architecture in the future – and are not adequately covered in the report.

## II. Assessment of IFAD’s financial architecture

5. Management is pleased to note that the report confirms Management’s own assessment – as reflected in the IFAD11 paper on country demand and IFAD’s capacity to deliver – that the demand for IFAD funding exceeds the size of its programme of loans and grants (PoLG). This is an important conclusion, as it underlines the continued relevance of IFAD as a key development organization with an important role to play in meeting the objectives of 2030 Agenda for Sustainable Development and the Sustainable Development Goals.

6. The report indicates that IFAD’s financial architecture is generally effective and efficient, although some areas could be strengthened to support financial sustainability. Management also notes that the evaluation recommendations are on the whole consistent with the broad directions agreed with Member States as part of IFAD11.

7. In reference to the foregoing, it is important to note that work to enhance IFAD’s financial model has already started. An internal working group has been set up to review the DSF mechanism, which has an important bearing on the Fund’s financial sustainability. The working group’s findings will be discussed with relevant IFAD governing bodies during the year. Additionally, an Executive Board working group has been set up on the transition framework and will present its findings to the

Board by the end of 2018. Work continues on exploring the feasibility of tapping capital markets. Steps are being taken to strengthen financial governance and risk management, and initiatives are in the works to improve financial management and sustainability.

8. IFAD welcomes the conclusion that the liquidity portfolio is being managed professionally. Regarding investment management, the report notes that existing policies and guidelines could be strengthened, and that IFAD's investment risk profile is higher than other IFIs. In this regard, Management is already at work to reduce its risk profile, and initial results – on the reduction of credit exposure, value at risk and duration – have been presented to the Audit Committee. More will be done in the coming months in terms of portfolio repositioning and risk reduction.

# III. Areas for improvement

9. Management appreciates the conclusions and recommendations included in the report. Going forward, Management is committed to further enhancing IFAD's financial sustainability and strategy in line with its renewed business model.

10. As the report indicates, there are areas that require further preparatory work and focus during the IFAD11 period. Management has committed (under monitorable action 3 of the IFAD11 commitments) to fully implement the roadmap for improving IFAD's financial strategy. The roadmap was agreed to during the IFAD11 Consultation and contains a number of activities to prepare for accessing capital markets in the future to meet increasing demand for assistance from developing countries and enhance long-term financial sustainability.

11. While the suggestion to raise lending rates contained in the evaluation report merits consideration, the report also highlights that the interest rates of IFAD loans on ordinary terms are generally competitive with those provided by other development financing organizations. Although the report contains some insights from the perspective of Member States on the possibility of such changes, a more thorough analysis would be warranted on the topic. Moreover, the report does not analyse the potential impact on country demand should IFAD deviate structurally and significantly from its current policy on lending terms.

12. To support Management's efforts, plans call for a comprehensive independent financial risk assessment by a third party consulting firm, which will address many of the issues and challenges raised in the evaluation report. A peer review may also be considered to benchmark IFAD's current approaches, and to enhance knowledge sharing and harmonization of good practices with other IFIs.

# IV. Management's observations

13. Overall, the CLE captures the main opportunities and challenges of the current financial architecture.

14. However, Management notes that the report would have benefited from fuller consideration of a number of current initiatives undertaken to address such issues as financial sustainability, risk management framework, currency alignment, product offering and flexibility, including lending terms. Management does recognize that the CLE analysis was done prior to finalization of the IFAD11 Report and related commitments.

15. In addition, the CLE would have benefited from a more in-depth analysis of reimbursable technical assistance (RTA) – an important instrument introduced by IFAD several years ago – and its implications on IFAD's overall financial strategy. RTAs are likely to be deployed more extensively, especially as part of IFAD's engagement in middle-income and upper-middle-income countries.

16. Management also notes that some of the CLE findings and recommendations are repetitions of issues already raised by IOE in previous evaluations. While Management acknowledges the need to reflect on these interrelated matters in such

a broad evaluation, they have been extensively discussed at a number of sessions of the Executive Board and Evaluation Committee along with Management's comprehensive responses on the way forward. One example is the analysis in chapter V where the CLE suggests extending the IFAD replenishment cycle from three to four years. The same recommendation was made by IOE in the CLE on replenishments (2014), and was not considered appropriate by either Management or the Executive Board. Another example is the performance-based allocation system (PBAS), which was covered separately and extensively in the CLE on the PBAS (2016). Management believes that the CLE report would have benefited from a full consideration of Management's responses to previous recommendations, and suggests that previous recommendations already followed up on should be avoided in new evaluations to ensure efficient feedback loops.

17. Management notes that the final CLE report contains some inaccuracies that were not addressed despite being flagged to IOE in Management comments on the draft CLE report. For example, DSF negative impact is recognized upon disbursement rather than upon approval as stated in the report.

# V. Recommendations to Management

18. Overall, Management welcomes and agrees with the CLE recommendations, which will contribute to improving its financial architecture more broadly with a focus on financial sustainability.

### Recommendation 1 – Address the problem of systematic financial losses, which leads to substantial capital erosion

| | Management response |
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| **1a** | **Agreed**<br>Management generally agrees with the proposals to improve financial sustainability and the need to look at various dimensions in a holistic way – in particular, to study in depth the link between the cost of resource mobilization and the terms at which these resources are being lent. Management would like to clarify that the option presented to move all DSF grants to a special purpose fund will, per International Financial Reporting Standards accounting requirements, need to be consolidated on IFAD's balance sheet. |
| **1b** | **Agreed**<br>Management takes note of the recommendation. In this context, Management will be implementing the roadmap of IFAD's financial strategy and developing the transition framework. |
| **1c** | **Agreed**<br>Management agrees with the recommendation, particularly on efficiency and the relative size of concessional and non-concessional products. |

### Recommendation 2 – Provide more flexible conditions for existing financial products and prepare for the introduction of new products

| | Management response |
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| **2a** | **Agreed**<br>Management takes note of the recommendation. Transition framework commitments will be implemented throughout IFAD11. |
| **2b** | **Agreed**<br>Management appreciates the recommendation. As per changes made to the Policies and Criteria for IFAD Financing approved by the Governing Council in February 2018, country classifications based on gross national income and creditworthiness are taken into consideration to determine eligible lending terms. Also, IFAD will make any transitions to hardened lending terms predictably and smoothly by applying the phasing-out/phasing-in mechanism. |
| **2c** | **Agreed**<br>Management takes note of the recommendation. Transition framework commitments will be implemented throughout IFAD11. |
| **2d** | **Agreed**<br>Monitorable action 6 for IFAD11 focuses on developing a strategy for private sector engagement and developing the Smallholder and Small and Medium-Sized Enterprise Investment Finance Fund (now Agri-Business Capital Fund [ABC Fund]). Recognizing that working with the private sector may require greater appetite for risk, the Financial Operations Department is working with the Programme Management Department on the introduction of ABC in order to support considerations that improve its financial sustainability, while Management is taking steps to mitigate risks with the vehicle's design, governance and recruitment of professional fund managers, currently under way. It is estimated that, at least initially, roughly |

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| | half of the resources may be invested through financial intermediation for the smallest deals. |

## Recommendation 3 – Revise the financial allocation system

| | Management response |
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| **3** | **Agreed**<br>While acknowledging the transparency of resource allocation, the report discusses in detail the limitations of the PBAS and its impact on financial sustainability. Management agrees that further revision of the resource allocation system may be needed. Management would like to recall that the current PBAS formula was approved only for IFAD11 and that Management and Executive Board have agreed to revise it for IFAD12. |

## Recommendation 4 – Conduct preparatory work for potential access to capital markets

| | Management response |
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| **4** | **Agreed**<br>Management is in agreement with the conclusions of the report in this area. A high credit rating will be crucial to IFAD's feasibility to run a hybrid funding model composed of core replenishment and debt funding. The comprehensive independent financial risk assessment will also be of use in highlighting next steps for IFAD in this regard. |

## Recommendation 5 – Use hedging instruments to better manage foreign exchange risks

| | Management response |
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| **5** | **Agreed**<br>The report's conclusions in this area are welcome and Management agrees. Special drawing right conversion is a complex exercise that would require an in-depth analysis including costs and risks. |

## Recommendation 6 – Strengthen IFAD's financial governance

| | Management response |
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| **6a** | This recommendation has been made to the governing bodies. |
| **6b** | **Agreed**<br>Management agrees on the importance of financial governance, including asset liability management at IFAD given its financial nature. |

## Recommendation 7 – Strengthen the efficiency of the replenishment process

| | Management response |
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| **7a** | **Agreed**<br>This recommendation has been made to the governing bodies.<br>The composition of the replenishment consultation is decided by IFAD's Membership at the Governing Council session. The balance of List A, B, and C representation has recently been reviewed by the Working Group on Governance. Based on the working group's recommendations, in 2017 the Governing Council adopted a resolution approving the transfer of four replenishment consultation seats from List A and List B to List C. This new formula took effect for the first time during the IFAD11 Consultation.<br>Management agrees that the voices of all its Member States should be heard during replenishment consultations, but also recognizes the need to ensure efficiency and effectiveness of the meetings. These issues were addressed by the Working Group on Governance. Management is committed to identifying ways to enhance dialogue within and among the Lists at the time of replenishment consultations to ensure that the views of all Member States are heard regardless of their direct participation. As in the past, observer status can be granted to non-members of the consultation. |
| **7b** | **Agreed in part**<br>Management notes that unrestricted complementary contributions (UCCs) (note that complementary contributions were removed in IFAD11) and supplementary funds (SFs) are fundamentally different in purpose and therefore have different governance mechanisms. Specifically, UCCs are part of core resources and part of replenishment funds used for the PoLG. The IFAD11 Resolution identified two thematic areas for UCCs: climate and nutrition. SFs, on the other hand, are not part of core resources or replenishment funds, but are used to channel grants from donors tied to a specific purpose. IFAD has no ownership of SFs, acting effectively as a service provider to agree on terms and monitor the use of funds together with the donor and recipients. IFAD also established procedures to fully recover the cost of acting as a service provider in managing SFs. Because of the difference in purpose, UCCs and SFs are also programmed and reported on separately.<br>Management agree to review the delegated authorities for the acceptance of supplementary funds. |