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Investing in rural people

Review of IFAD's Debt Sustainability Framework and Proposal on Future Approach

Note to Executive Board representatives

Focal points:

Technical questions:

Alvaro Lario
Associate Vice President,
Chief Financial Officer and Chief Controller
Financial Operation Department
Tel.: +39 06 5459 2403
e-mail: a.lario@ifad.org

Advit Nath
Director and Controller
Accounting and Controller's Division
Tel.: +39 06 5459 2829
e-mail: a.nath@ifad.org

Allegra Saitto
Chief Financial Reporting and
Corporate Fiduciary
Tel.:+39 06 5459 2405
e-mail: a.saitto@ifad.org

Dispatch of documentation:

Deirdre McGrenra
Chief
Governing Bodies
Tel.: +39 06 5459 2374
e-mail: gb@ifad.org

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Executive summary

1. The Debt Sustainability Framework (DSF) was adopted as a preventative measure to avoid the increasing national debt of poor countries. Countries eligible for DSF financing receive financial assistance on a grant basis rather than on a loan basis. Member States agreed to compensate the international financial institutions (IFIs) participating in this framework for the reflows that would have occurred if financing had been issued through loans.

2. IFAD's Audit Committee and Executive Board have been provided with quantitative data and a detailed simulation of future obligations under the DSF framework as well as a detailed comparison with the practices of other IFIs.[1] Risks resulting from the DSF have been highlighted during previous replenishment consultations.

3. While DSF does provide grant funding to selected countries, the DSF compensation mechanism has a negative impact on IFAD's cash flows and capital. This impact, as demonstrated by a forecasting analysis presented at the March 2018 meeting of the Audit Committee and the April 2018 meeting and Executive Board, will likely have repercussions on IFAD's ability to deliver on its mandate and continue to support its programme of work. The recent corporate-level evaluation of IFAD's financial architecture by the Independent Office of Evaluation of IFAD, as well as an independent financial risk assessment conducted by Alvarez and Marsal Financial Industry Advisory Services confirmed the need to review the DSF mechanism in order to ensure IFAD's long-term financial viability and continued achievement of its objectives.

4. The aim of this document is to present potential areas for consideration in order to improve the DSF mechanism's resource sustainability and support a growing programme of loans and grants – facilitating IFAD's transformation to a new financial architecture and long-term sustainability.

5. As requested by Member States, the Audit Committee and Executive Board, Management has prepared for review by the Audit Committee and Executive Board three options for consideration:

   - Option 1: Reinforcing the additionality of DSF compensation due to IFAD, effectively making the compensation mandatory or formal burden sharing;
   - Option 2: Creation of a separate replenishment window for DSF and reinforced DSF eligibility criteria; and
   - Option 3: Discontinuing of DSF financing from IFAD12 onwards.

[1] See the documentation provided at IFAD's Tenth and Eleventh Replenishment Consultations, annual updates to Audit Committee and Executive Board (up to the Board's 123rd Session in April 2018) and the Executive Board informal seminar in June 2018.

I. Background

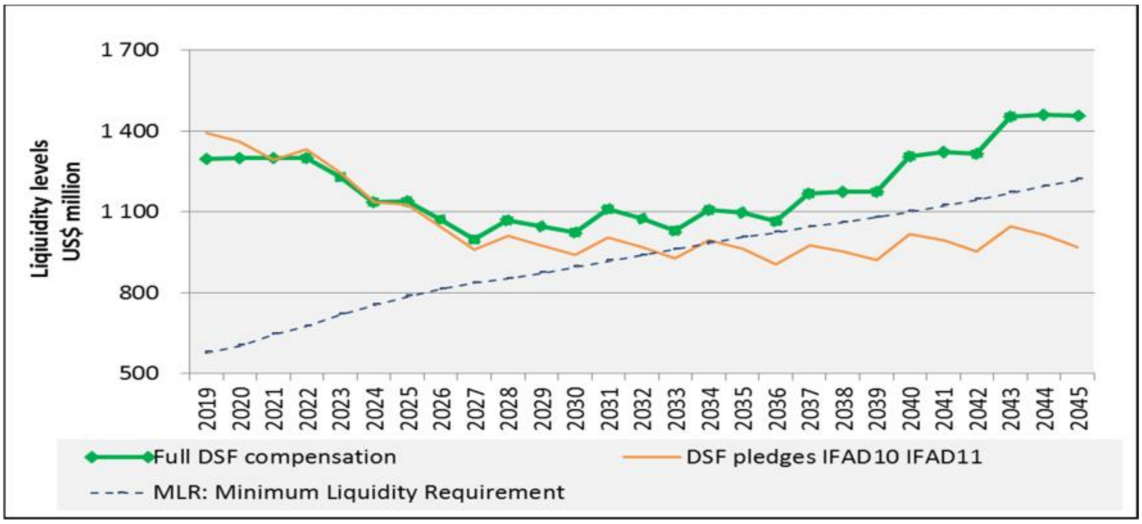
6. The Debt Sustainability Framework (DSF) was adopted by IFAD in 2007 to support debt management in poor countries. DSF is a hybrid mechanism created to provide financing to developing countries on a grant basis rather than on a loan basis (on highly concessional terms), thus avoiding the creation of debt for DSF recipients. This mechanism was created in line with the principle of financial neutrality for the institution adhering to this framework. IFAD's Member States agreed to fully compensate the Fund for principal repayments (over the 40-year maturity period, including a ten-year grace period, similar to a highly concessional loan).

7. As of 31 December 2017, IFAD had committed approximately US$1.7 billion[2] in DSF financing, of which disbursements amounted to US$933 million);[3] this financing is expected to be repaid in the period up to 2056.

8. As of 30 September 2018, US$2.9 million had been received in DSF pledges through the Tenth Replenishment of IFAD's Resources (IFAD10) and US$31 million had been received for IFAD11, compared with the DSF compensation targets of US$3.4 million and US$39.5 million respectively. The current DSF compensation mechanism will have an increasing financial impact in future replenishment periods, when the volume of expected compensation will be significantly higher (the estimate for IFAD12 is US$89.5 million). It would not be possible to finance DSF compensation through borrowing activities since DSF terms correspond to grants and are therefore not sustainable under any borrowing scenario.

9. Figure 1 below illustrates the financing gap between IFAD liquidity levels in the case of a full DSF compensation (green line), and liquidity levels based on DSF pledges received towards IFAD10 and IFAD11 (orange line). The graph shows that liquidity projections based on DSF pledges currently received (orange line) will not meet IFAD's minimum liquidity requirements (blue line).

Figure 1: Projected liquidity levels based on full DSF compensation compared to projected liquidity levels based on DSF pledges received



10. While DSF implementation has enabled many recipient countries to avoid accumulating national debt, the current DSF modality generates an immediate negative impact on IFAD's accounts. There are timing differences in cash flows and accounting treatment: while disbursements for DSF projects are recorded immediately as outflows, DSF compensation is received with a 10-year delay and

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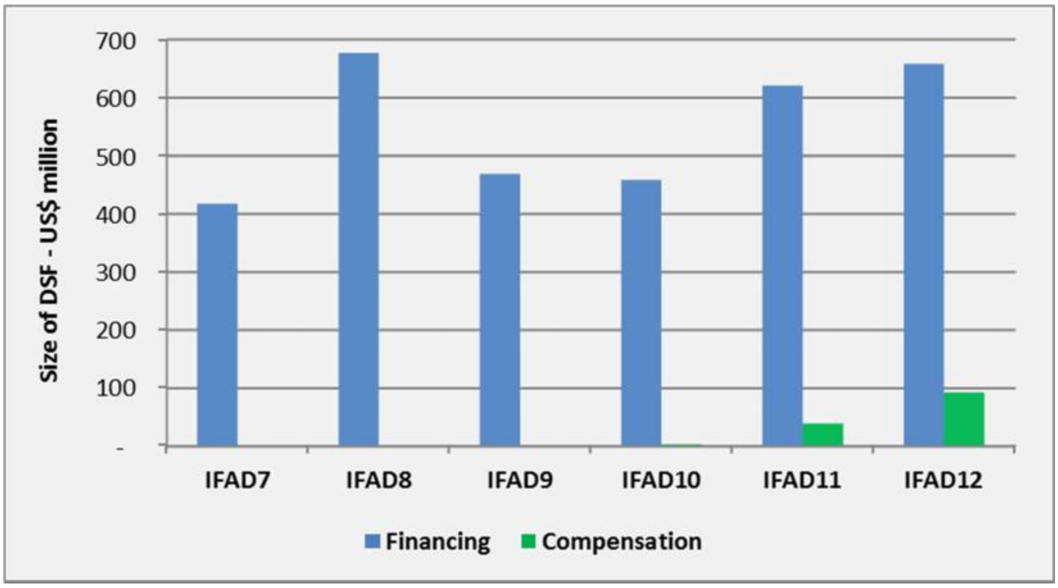
[2] SDR/US$ exchange rate as of 31 December 2017.
[3] SDR/US$ historical spot exchange rates when disbursed.

over a period of 40 years. Figure 2 below provides an illustration of the timing differences between DSF financing (disbursements) and the requested receipt of DSF compensation.

Figure 2: Size of DSF financing and size of compensation due



11. If DSF commitments are not adequately compensated as additional contributions towards core resources, there will be negative repercussions on IFAD's resources, limiting the Fund's capacity to carry out its mandate with a possible reduction in its programme of loans and grants (PoLG).

12. The negative implications of DSF have been reported to the Audit Committee and the Executive Board regularly since the DSF's inception in 2007. In response, IFAD has undertaken comparison studies with other international financial institutions (IFIs). Actions include:

- A progress report on DSF implementation provided on a yearly basis to the Audit Committee and Executive Board since the DSF's inception in 2007 (in March and April 2018, this report was expanded to include forward-looking impact and scenarios as well as historical impact);[4]
- Detailed reporting inclusive of quantitative analysis and effects of DSF implementation was presented to the IFAD10 and IFAD11 Consultations,[5,6] providing comparisons with other IFIs with DSF mechanisms and including options to address financial sustainability issues; and
- An Executive Board informal seminar in June 2018 to provide background information on this topic.

13. During 2018, a corporate-level evaluation (CLE) of IFAD's financial architecture was conducted by the Independent Office of Evaluation of IFAD with the purpose to evaluate how effectively IFAD's policies and systems are adapted to mobilize, manage, allocate and disburse resources to fulfil IFAD's mandate. The evaluation also considered IFAD's long-term financial sustainability and contribution to the 2030 Agenda For Sustainable Development. CLE results were presented at the

[4] See document EB 2018/123/R.36/Rev.1, Financial Impact of Principal Due and Service Charges Forgone as a Result of the Implementation of the Debt sustainability Framework.
[5] See IFAD11/2/R.6, Review of IFAD's Debt Sustainability Framework and Proposal on Future Approach and IFAD10/3/R.4, Review of status of Debt Suitability Framework.
[6] Resolution 203/XLI regulates DSF compensation for IFAD11.

101st session of the Evaluation Committee, the 150th meeting of the Audit Committee meeting and the 124th session of the Executive Board.

14. The CLE identified DSF as a critical factor to be addressed to ensure IFAD's long-term financial sustainability. One of the key risks identified by the evaluation was the negative effect generated by a possible shortfall in DSF compensation. The need to improve the predictability of DSF compensation mechanisms to avoid capital erosion was recommended through many means including the establishment of a pre-funded DSF window.[7]

15. DSF was also highlighted as a major financial risk by the recent independent financial risk assessment conducted by Alvarez and Marsal Financial Industry Advisory Services, and reported to the Executive Board at an informal seminar in October 2018.

II. Potential areas for consideration

16. Fully supporting the outcome of the CLE and the financial risk assessment, Management aims to provides some analysis to: (i) improve the compensation requirements derived from historical DSF commitments; and (ii) reduce the accumulation of additional DSF burden.

17. This analysis examined the timeliness and certainty of DSF compensations, and the volumes allocated to the DSF financing mechanism in order to ensure long-term financial and operational sustainability in view of IFAD's enhanced borrowing activities. The paragraphs below highlight potential areas for further assessment in order to ensure generate positive impacts IFAD's financial sustainability, soundness, liquidity, and support from Member States. These considerations are not mutually exclusive and may be considered complementary. Their implementation would take place from IFAD12 onwards.

Separate replenishment window for DSF (allocation towards DSF financing based on ex-ante pledges)

18. From IFAD12 onwards, create a separate replenishment window specific to DSF. Resources would be allocated to DSF financing based on the level of pledges earmarked under this specific window. Full up-front DSF funding would be ensured while Member States would continue to compensate for the DSF burden accumulated up to IFAD11 as per the current practice.

19. This would: promote long-term financial sustainability; avoid the creation of additional DSF burden in the future; and increase funding predictability by creating certainty of future DSF cash flows. The level of DSF financing would depend on the level of pledges made through the dedicated DSF replenishment window.

20. This option would be reflected in future replenishment resolutions to be adopted by the Governing Council; it may imply a revision of the DSF formula. The scenario would generate a positive impact on IFAD's liquidity and long-term financial sustainability. DSF compensation for commitments accumulated up to IFAD11 should continue to be ensured as currently scheduled.

DSF compensation with an accelerated compensation profile

21. DSF compensation currently mirrors the amortization schedule of highly concessional loans, with a 40-year maturity period, including a 10-year grace period. Acceleration of the DSF compensation schedule from IFAD12 onwards could

[7] Detailed recommendations arising from the evaluation and Management's response can be found in documents EB 124/124/R.7 and EB 124/124/R7/Add.1.

be considered. There could be several possible scenarios,[8] one of which could imply compensation over a 10-year period, including a three-year grace period.

22. This scenario would address concerns related to compensation for the burden already accumulated and would also ensure timely compensation of future DSF commitments. It would generate a positive impact on IFAD's liquidity and long-term financial sustainability, and would not have implications on DSF recipient countries.

23. However, this option would mean earlier payment by Member States contributing to DSF compensation, creating a larger burden initially but less burden in the future.

24. Steps to implement this scenario would include endorsement of a replenishment resolution by the Governing Council in the context of IFAD12 replenishment consultations. This scenario would generate a positive impact on IFAD's liquidity and long-term financial sustainability, and DSF compensation for commitments accumulated up to IFAD11 would continue as scheduled.

Reinforcing the additionality of DSF compensation as a result of IFAD making DSF compensation mandatory or formal burden sharing

25. Member States' commitment to compensating the Fund for principal forgone as a result of DSF implementation is embedded in the Report of the IFAD7 Consultation adopted by the Governing Council in 2006.[9] This commitment was reaffirmed in the IFAD10 and IFAD11 replenishment resolutions.[10]

26. In order to increase the certainty of future compensation and Member States' support, DSF compensation could become mandatory or more formally as a burden sharing. While, this measure would not address the asymmetries and the time lags in cash inflows and outflows, it would ensure strong financial support from Member States. Voting rights would continue to be calculated as per the current procedure and DSF compensation would be identified as a clear target in the replenishment resolution.

27. Steps to implement this measure as mandatory would imply a revision of the Agreement Establishing IFAD since DSF compensation contributions are considered as additional contributions within article 4, section 3 of the Agreement, which covers voluntary contributions made in the context of any given replenishment.

28. This scenario would generate a positive impact on IFAD's liquidity and long-term financial sustainability, and DSF compensation for commitments accumulated up to IFAD11 should continue to be ensured as currently as scheduled. This scenario would not have implications on DSF recipient countries.

Creation of new lending terms for very highly concessional loans

29. This consideration would imply discontinuing or reducing the deployment of DSF funding from IFAD12 onwards while providing financing on a loan basis with terms more concessional than highly concessional loans. It would involve the creation of new lending terms, with a 50-year maturity period, including a 10-year grace period. Recipient countries would receive a lower volume of assistance on a grant basis. This would avoid the creation of a future DSF burden to be compensated; DSF compensation for commitments accumulated up to IFAD11 would continue as scheduled.

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[8] An accelerated compensation period would present several alternatives, among them compensation over 25 years, including a five-year grace period, and compensation over 20 years with a five-year grace period.
[9] IFAD's Contribution to Reaching the Millennium Development Goals: Report of the Consultation of the Seventh Replenishment of IFAD's Resources (2007-2009), para. 43 (GC29/L.4).
[10] IFAD10 replenishment resolution (Resolution 186/XXXVIII) and IFAD11 replenishment resolution (Resolution 203/XLI).

30. This scenario would generate a positive impact on IFAD's liquidity and long-term financial sustainability, and DSF compensation for commitments accumulated up to IFAD11 should continue to be ensured as currently scheduled.

Enhancing DSF eligibility criteria

31. While this consideration would ensure the continued application of the DSF framework, it would involve the revision of eligibility criteria for DSF financing, requiring a more consistent country debt sustainability assessment. DSF approvals would be managed within a sustainable range (for example, from 17 per cent to 10 per cent) along with an increased allocation to highly concessional loans.

32. Under this scenario, long-term financial sustainability would be ensured by higher liquidity generated by a reduction of funds deployed as DSF grant financing. Member States would compensate a lower future volume of DSF commitments; however recipient countries would receive a lower volume of assistance on a DSF grant basis. DSF compensation for commitments accumulated up to IFAD11 would continue as scheduled.

33. In line with the ongoing review of the DSF by the International Monetary Fund (IMF) and the World Bank, IFAD's Management is already undertaking a thorough review of country eligibility criteria while establishing a systematic process. For some countries, the results provided by IMF and the World Bank are complemented by IFAD's own assessments based on: (i) comparisons with peer institutions' lending terms; (ii) IFAD's own measurement of countries' creditworthiness based on the Fund's country ratings; (iii) countries' track records of repayments to IFAD, classification and lending terms; (iv) assessments of the impact of projected investments in terms of growth, exports and fiscal adjustment; and (v) access to markets and debt profiles in market terms.

Discontinue the DSF mechanism in its current form from IFAD12 onwards

34. This consideration would imply discontinuing the deployment of DSF funding from IFAD12 onwards, and increasing financing on highly concessional terms; recipient countries would receive assistance on a loan basis.

35. This consideration would ensure IFAD's long-term financial sustainability through higher liquidity generated by a reduction in the future DSF burden. Recipient countries would receive financing on a loan basis on highly concessional terms and Member States would need to compensate a lower volume of DSF burden.

III. Options

36. All the considerations described above aimed to ensure the IFAD's long-term financial sustainability while enabling the full delivery on its mandate. These considerations would address issues related to the accumulation of the DSF burden and its compensation, and would increase funding predictability. However, the financial scope and consequences of their implementation varies. On this basis, Management proposes three options for review and comment by the Audit Committee and Executive Board:

Option 1: Reinforcing the additionality of DSF compensation due to IFAD, effectively making the compensation mandatory or formal burden sharing.

37. With a view to continuing the DSF mechanism, the most sustainable option is to make DSF compensation mandatory or a formal burden sharing. To this end, an amendment to the Agreement Establishing IFAD would be required along with the adoption of the proposed change by the Governing Council as a majority of four fifths of the total number of votes.

38. This option would create full certainty of future cash flows and Member States' capital support. Detailed assumptions are described in paragraph 25 to paragraph 28 above.

Option 2: Creation of a separate replenishment window for DSF and reinforced DSF eligibility criteria.

39. This option, as detailed above in paragraphs 18 to 20, and paragraphs 31 to 33, would:

- Ensure certainty of future DSF cash flows;
- Reduce the accumulation of future DSF burden;
- Provide DSF financing based on the level of pledges received during replenishment consultations; and
- Ensure DSF financing equivalent to the allocation of the performance-based allocation system through the enhancement of eligibility criteria (with a sustainable level of approximately 10 per cent).

If endorsed, this option would be reflected in all future replenishment resolutions.

Option 3: Discontinuing of DSF financing from IFAD12 onwards.

40. This option would avoid the creation of additional future DSF burden (details are provided in paragraphs 34 and 35 above). Management acknowledges that, given the potential impact this option would have on IFAD's poorest Member States, it could be complemented by the introduction of a loan on highly concessional terms to replace DSF grants. However, Member States would need to continue honouring the DSF burden already accumulated. Compensation would be provided a period of 40 years as per the current methodology.

Comparison of options

41. These three options would impact cash liquidity projections at various levels. Figure 3 below illustrates these effects and compares the options with liquidity projections based on: DSF pledges currently received (illustrated with an orange line), which do not meet IFAD's minimum liquidity requirements (illustrated with a blue line). All options would improve IFAD's long-term financial sustainability by generating liquidity above minimum liquidity requirements.

42. It should be noted that:

- Among the options presented, the liquidity levels generated under option 1 – reinforcing the additionality of DSF compensation to IFAD – which effectively makes this compensation mandatory, results in the lowest level of future sustainable PoLG. This is because the associated assumptions do not alter the timing of the current DSF compensation mechanism or modify future deployment of funds on a DSF basis. While interest may be largely forgone, principal compensation would remain due in 40 years, including a 10-year grace period.
- The liquidity levels associated with option 3 – discontinuing DSF approvals – imply deployment of funds on a loan basis with repayments on highly concessional terms (40-year repayment period, including a 10-year grace period and a service charge of 0.75 per cent). Option 3 generates higher liquidity levels than option 1 because this scenario also considers full interest repayments.
- Liquidity levels derived from option 2 – creation of a separate replenishment window – are the highest among the three options. This option is preferable because it addresses concerns related to the accumulation of future DSF burden and provides a certainty of future cash flows (DSF pledges would be based on forecasts) and Member States' support. Option 2 would therefore guarantee the future growth of IFAD's PoLG.

Figure 3: Liquidity projections associated with each of the three options