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Update of Financing Terms

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Abbreviations and acronyms

AfDF	African Development Fund
ALM	asset liability management
AsDB	Asian Development Bank
DSF	Debt Sustainability Framework
EURIBOR	Euro Interbank Offered Rate
GNIpc	Gross National Income per capita
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFI	international financial institution
LMIC	lower-middle-income country
LIBOR	London Interbank Offered Rate
PBAS	performance-based allocation system
PCIF	Policies and Criteria for IFAD Financing
SDR	special drawing right

Recommendation for approval and transmittal to the Governing Council

The Executive Board is invited to:

(a) Consider and approve this document, which includes, as annex VI, a Governing Council draft resolution; and

(b) Approve the transmittal of the draft resolution provided in annex VI of the document to the Governing Council, including the recommendation that the Governing Council adopt the draft resolution at its forty-second session.

Executive summary

I. Context

1. The proposed update of financing terms facilitates the delivery of IFAD's largest programme of work to date for IFAD11. It tailors IFAD's financing terms to different strategic topics such as the fragility of small states economies and countries in transition, provides greater flexibility for ordinary-term borrowers and modernizes the Policies and Criteria for IFAD Financing within the current pricing methodology.

2. The recent Corporate-level Evaluation of IFAD's Financial Architecture[1] called for an update of the current methodology for determining IFAD's variable interest rate; and for considering borrowers' demands and the agility provided by the financial instruments of other international financial institutions (IFIs). The reform process connected with the Eleventh Replenishment of IFAD's Resources (IFAD11) calls for changes such as those contained in this document in order to tailor IFAD's operations to country demand and develop IFAD's financial framework.

II. Proposed changes

3. This document recommends the following changes:

   (a) Ordinary terms:

      (i) Offer variable spread loans with different "buckets" of maturities/grace periods and set pricing accordingly;

      (ii) Introduce a fixed spread using different buckets of maturities as per the International Bank for Reconstruction and Development (IBRD); this is not a fixed interest rate since the base London Interbank Offered Rate (LIBOR) is variable; and

      (iii) Introduce a differentiated maturity premium (surcharge or discount) by income category of borrower (as announced by World Bank in April 2018).

   (b) Highly concessional and blend terms: introduce matching of service charge and interest (blend only) financing terms, to the financing denomination currency.

   (c) Highly concessional terms:

      (i) Small states economies: introduce a new repayment profile – 2 per cent for years 11-20 and 4 per cent for years 21-40 – in order to

[1] See EC 2018/101/W.P.5.

increase the degree of concessionality while maintaining the current maturity and grace periods of 40 and 10 years respectively; and

(ii) Regular highly concessional terms: introduce a new repayment profile – 4.5 per cent for years 11-30 and 1 per cent for years 31-40 – in order to align with other IFIs' lesser concessionality while maintaining the current maturity and grace periods of 40 and 10 years respectively.

(d) All loans: Set interest rates on a quarterly basis using the 6 month LIBOR.

III. Rationale

4. These proposals: (i) facilitate debt and risk management, and planning practices for both borrowers and IFAD, including foreign exchange exposure; (ii) reflect IFAD's niche, in which a typical project funded by IFAD has a longer return on investment; and (iii) provide IFAD's reply to borrowers' demands for an extended set of financial offerings.

5. The current proposals for ordinary terms maintain the basic methodology approved by the Executive Board to determine IFAD's variable interest rate, which is pegged to the International Development Association (IDA)/IBRD rate. Continuing with business as usual may lead borrowers to opt for other sources of financing since IFAD's pricing could be perceived as too expensive, especially for countries eligible for discounts and exemptions elsewhere.

6. The above-mentioned changes are financially sustainable overall and will result in faster reflows, ultimately making more resources available to borrowers and reducing foreign exchange impact on IFAD. They will also allow more flexibility to ordinary-term borrowers, mitigating the perception that IFAD financing is too expensive by offering spreads commensurate with the related ordinary terms maturity bucket.

IV. Implementation of changes: legal, risk management and administration

7. The financial impact of these changes considers IFAD's financial sustainability in line with the 60 per cent minimum liquidity requirement ratio approved by the Executive Board. The financial scenarios used in this document were developed based on Management's best estimates within the current financial model; however actual results may vary from those expected.

8. Implementation of the above proposed changes will require the following:

(a) An amendment to the Policies and Criteria for IFAD Financing to be approved by the Governing Council for: (i) the introduction of differentiated maturity and grace periods for ordinary terms; (ii) the introduction of currency-specific loan pricing (to be determined by the Executive Board) for highly concessional and blend terms; and (iii) a change of frequency for the review and revision of the IFAD service charge and the reference interest rate.

(b) A revision to the IFAD methodology to determine the ordinary and intermediate interest rates charged to borrowers as approved by the Executive Board during its ninety-seventh and ninety-eighth sessions in September and December 2009. These revisions should cover: (i) a fixed spread and its related determination; (ii) the maturity premium differentiation based on income category; and (iii) the differentiation of the amortization profile of highly concessional loans provided to small states economies and other eligible borrowers. These changes will need to be approved by the Executive Board.

9. The proposed changes will be implemented through a rollout package including internal and external communications, and capacity-building for staff and stakeholders to manage different borrower options and integrate more complex risk management and asset liability management.

10. IFAD will also adjust its procedures and manuals for communication, loan administration, accounting and management, and ensure that internal and external systems and capacities are built and maintained over time. The proposed changes to financing terms will be integrated into the current transparency action plan in line with Management's commitments (see EB 2017/122/R.29/Rev.1). This will allow additional information on financing terms and rates, and product notes to be made available by the start of 2019.

V. Conclusion

11. This set of proposals forms part of IFAD's transformative package of enhanced responsiveness. By providing more options for borrowers, it aims to balance the interests of different borrowers. While recognizing that there may be trade-offs for individual countries, it is focused on providing a broad package of options and value for all stakeholders. IFAD Management plans to propose systematic updates along with new instruments and products in order to respond better to borrower requests and adapt to IFAD's evolving financial architecture.

Update of IFAD's Financing Terms

I. Background and approach

1. During the Consultation on the Eleventh Replenishment of IFAD's Resources (IFAD11), Management agreed with IFAD stakeholders to embark on an ambitious reform process through an enhanced business model that will maximize its long-term contribution to development. To achieve these goals, IFAD plans to undertake a series of operational and financial changes to streamline and modernize its policies and procedures, and tailor operations to support country demands and the needs of borrowing Member States.

2. This document responds to the challenge of implementing IFAD11 commitments by proposing an update of IFAD's financing terms. No significant changes have been made to IFAD's financing terms in recent years – at least not in the holistic way proposed in this document. IFAD's current business model has been successful in realizing a robust programme of loans and grants in recent replenishments. Nevertheless, a distinct change in the business model for IFAD11 will enable the Fund to meet its ambitious global targets. Management considers it timely to present this proposal for change, recognizing the many areas in need of updating and the necessity of implementing changes gradually and building adequate internal capacity and systems. This proposal focuses on the areas with the most compelling and urgent need for change.

3. In preparing the inputs for this document, Management has made efforts to:

   - Tailor operations to support the demands and needs of borrowers, providing greater comparability of the financial products offered by IFAD with those of other financial institutions (IFIs);
   - Address strategic topics such as the fragility of small states economies, and borrowers in transition;
   - Enhance IFAD's financial sustainability through both accelerated loan reflows by offering more optional shortened loan maturities and enhanced currency risk management and asset liability management (ALM);
   - Provide borrowers more flexibility in their debt management and financial risk mitigation strategies by differentiating pricing by average repayment period, introducing further options in maturity and grace periods, and offering a fixed spread option;
   - Engage in a differentiated way with borrowers in development transitions; and
   - Holistically review the risks related to introducing the proposed changes and mitigation measures.

4. This proposal forms part of IFAD's transformative package for enhanced responsiveness and attractiveness by providing more options for borrowers. It aims to balance the interests of different groups of borrowers. While recognizing that there may be trade-offs for individual countries, its objective is to formulate an overall package that offers options and value for all stakeholders.

II. IFAD's current terms and methodology, and comparison with practices of other IFIs

5. A benchmarking analysis of IFAD's practices compared with loan pricing adopted by peer IFIs[2] indicates that compared to IFAD, all peer institutions have an extensive and agile repertoire of financing products, loan pricings, maturities and denomination currencies. This allows them to offer flexibility, including conversion of loan currency, conversion of loan spread from variable to fixed and vice-versa, and acceleration of repayments. An analysis of these offers is provided in the appendix.

6. As stated in the Policies and Criteria for IFAD Financing (PCIF), IFAD currently has three financing products:

- Loans on highly concessional terms, blend terms and ordinary terms;
- Grants; and
- Grants through the Debt Sustainability Framework (DSF).

III. Rationale and recommendations for changes in financing terms

7. The detailed proposals and rationale for changes are presented below, and summarized in annex I. Further details on the proposed changes, including their financial impact on IFAD's liquidity and the amendments that will be required in legal documents are provided in the annexes. The overall financial impact on IFAD's liquidity is sustainable, with an approximate positive reflow of US$760 million over 50 years. This result was derived after individually testing the impact of each assumption on IFAD's liquidity. It is therefore reasonable to assume that the overall impact of all assumptions tested simultaneously can be represented as an average of each result.

A. Ordinary term loans: Differentiated pricing by average repayment period

8. A standard IFAD ordinary loan has a maturity period of 15 to 18 years, including a grace period of three years. The price of this loan is based on a floating reference rate[3] plus the variable spread of IBRD,[4] which is used as a proxy for IFAD's funding cost.

9. During IFAD9 and IFAD10, IFAD received formal requests for a different maturity period from 18 of the 23 ordinary-term borrowers due to receive financing in IFAD11; for the first time in IFAD's history, one borrower opted for a shorter maturity period (see box 1 below). During IFAD10, 10 ordinary term borrowers asked IFAD to base its pricing on the average repayment maturity of the underlying financing terms.

Box 1
Introduction of variable spread differentiation based on maturity bucket

Resilience and diversification in Iraq. In 2017, the Smallholder Agricultural Revitalization Project (EB 2017/LOT/P.10/Rev.1) was financed by an IFAD loan of US$15.73 million and two grants totalling US$2.5 million. The loan was granted on ordinary terms with a shorter maturity period of 10 years including a grace period of three years. The interest rate charged by IFAD is in line with the rate offered by IBRD for its highest maturity bucket (i.e. maturity greater than 18 to 20 years). Were the Government to have begun repayments, IFAD would apply the usual ordinary loan interest rate of LIBOR + 0.97 per cent, whereas the applicable IBRD rate for an average maturity period of eight years and below would be LIBOR + 0.47 per cent.

[2] Peer IFIs include the World Bank Group, African Development Bank, Asian Development Bank (AsDB) and Inter-American Development Bank (IDB).
[3] For example, the six-month United States dollar LIBOR.
[4] Highest average repayment "maturity bucket" of IBRD (i.e. loans with an average maturity of 18 to 20 years).

10. Allowing borrowers to tailor the maturity and grace periods of a loan, and reflecting the related pricing based on the resulting average repayment period, will provide more flexibility in borrowers' debt management and risk-mitigation strategies, and allow them to choose financing terms in line with projects' expected economic and financial impact. It has been proposed that IFAD further align with IBRD's flexible approach by allowing borrowers to choose up to a maximum maturity of 35 years and an average maturity of 20 years, adjusting the variable spread according to the average loan maturity (see annex II, sections II and III) with a maximum grace period of ten years.

B. Ordinary term loans: Introduction of option of fixed spread

11. A fixed spread loan offers borrowers an interest rate comprising: a floating interest rate component (e.g. LIBOR, Euro Interbank Offered Rate [EURIBOR]), which is updated periodically to reflect market changes; and a fixed spread component, which remains constant over the life of the loan. Thus, the interest rate on the loan is only subject to market fluctuations that affect the floating interest rate (LIBOR, EURIBOR, etc.). IFAD does not currently have a fixed spread option. Several borrowers have requested fixed spread loans, especially for mitigating risk in certain projects (e.g. rural finance operations).[5] Such loans will facilitate project design and implementation, and ease access to financing, providing more stability for onlending and enhancing project impact.

Box 2
Operational benefits of the introduction of fixed spread loans

Rural finance in Jordan. IFAD has provided Jordan loans on ordinary terms totalling US$11.3 million and US$8.4 million for the Rural Economic Growth and Employment Project and the Small Ruminants Investment and Graduating Households in Transition Project respectively. Approximately US$10.6 million has been dedicated to the establishment of a rural finance fund to support the development of rural micro, small and medium-sized enterprises. The fund aims to reduce collateral requirements for new investment loans and improve the bankability of new investment loan proposals. At the design stage, the Central Bank of Jordan, as this component's implementing agency, requested a fixed spread. This was because the microfinance institutions providing loans to beneficiaries requested a more predictable interest rate in order to maintain the competitiveness of lending costs in the medium term. A fixed spread loan could facilitate higher beneficiary participation through the provision of credit on more concessional terms.

Table 1
Introduction of maturity and grace period options, differentiated pricing and fixed spread

Financing terms	*Current position*	*Change description*	*Considerations*
Ordinary	Maturity period up to 18 years; grace period pegged to three years	Offer maximum maturity periods of up to 35 years, with an average maturity period of 20 years. Maximum grace period of 10 years.	• Volume of expected original performance-based allocation system (PBAS) resources: US$900 million. • Flexibility for borrowers to manage debt. • No significant overall financial impact for IFAD. • Increase in risk with fixed spread. • Depending on demand for fixed spread loans, this change could result in US$700 million in additional liquidity over 50 years.
	No differentiation in pricing	Introduce pricing according to average repayment maturity buckets of IBRD.	
	No fixed spread offered	Introduce fixed spread with options for grace and maturity periods. Introduce pricing according to average maturity bucket of IBRD.	

[5] The fixed spread is usually higher than the variable spread since it incorporates a market risk premium that compensates IFAD for potential fluctuations in its own funding cost over the length of the loan.

C. Ordinary term loans: Introduction of maturity premium differentiation between income categories

12. The IBRD variable spread on which IFAD's pricing methodology is based comprises various elements, including a contractual spread, a maturity premium and a charge to cover IBRD's average funding cost. The maturity premium increases with the length of the maturity of the loan. In July 2018, IBRD introduced a standard set of maturity premium increases, returning to its historical practice of adjusting the maturity premium based on the borrower's income.[6] The maturity premium will increase between 10 and 40 basis points[7] for loans with an average maturity of longer than 10 years. There is an increase of 40 basis points for loans with an average maturity of 18-20 years – the bucket currently used by IFAD for its ordinary term pricing. Countries classified by IBRD as high income[8] will see an additional surcharge of 5 to 25 basis points depending on the average maturity, while countries with a GNIpc lower than or equal to US$6,795[9] will receive a discount of 5 to 20 basis points. Countries on blend terms, small states economies, fragile situations (as per the World Bank harmonized list) and recent IDA graduates are exempt from the increase in the maturity premiums.

13. Effective 1 January 2019, IFAD will need to implement an increase in maturity premium ranging from 0 to 40 basis points[10] on top of the current charge of 50 basis points. This forms an inherent part of the IBRD spread and IFAD has been pegged to IBRD's highest average repayment maturity bucket since 2009. The expected allocation for IFAD11 borrowers does not include any country to which a surcharge would apply. However, a significant portion of the IFAD11 PBAS allocation (approximately US$626 million or 71 per cent of countries borrowing on ordinary terms) is to countries with a GNIpc less than or equal to US$6,795 and those considered exempt.

14. Continuing with business as usual may lead borrowers to opt for other sources of financing since IFAD's pricing can be perceived as too expensive, especially for countries eligible for discounts and exemptions elsewhere. In fact, the Corporate-level Evaluation of IFAD's Financial Architecture[11] found that between IFAD7 and IFAD9, lower-middle-income countries (LMICs) and upper-middle-income countries used only 90 per cent and 75 per cent respectively of their original PBAS allocations. This low absorption may continue into IFAD11; a plausible explanation is the non-competitiveness of IFAD's offer.

15. Management proposes introducing maturity premium adjustments similar to IBRD's, but adapted to IFAD's context in order to preserve its basic principles and provide further flexibility. IFAD will use the GNIpc thresholds established (and updated annually) by the World Bank to determine the appropriate maturity premium applicable to each borrower. IFAD borrowers exempt from the maturity premium increase, as described in the previous paragraph, will include: (i) fragile states; (ii) small states economies; (iii) countries transitioning from blend to ordinary terms; and (iv) as an extraordinary measure for IFAD11, countries that became eligible for ordinary terms during IFAD9 or IFAD10.[12] The final exemption is proposed as part of the transition process to support borrowers which are changing their lending terms.

[6] Based on gross national income per capita (GNIpc) calculated using the Atlas method.
[7] One basis point: one hundredth of one percentage point (used chiefly in expressing differences of interest rates).
[8] For fiscal year 2019, countries with a GNIpc greater than US$12,055.
[9] For fiscal year 2019, this is the income threshold at which IBRD begins discussions with borrowers on graduating from IBRD lending.
[10] The increase of 0 to 40 basis points assumes that the maturity and grace period differentiation proposed in the previous section is implemented. If not, IFAD will apply a 40 basis point increase on its current loan offer.
[11] See footnote 1.
[12] The countries are: Angola, Armenia, Bolivia (Plurinational State of), Bosnia and Herzegovina, Georgia, India, Philippines, Sri Lanka and Viet Nam.

16. Presuming that this package of proposals is approved by the Executive Board in December 2018, most ordinary-term borrowers would have a choice of maturity premiums as low as 20 basis points for loans with an average maturity of 10 to 12 years. See annex II, section IV for additional details.

Table 2
Introduction of maturity premium differentiation between income categories

Financing terms	*Current position*	*Change description*	*Considerations*
Ordinary	No differentiation in maturity premium by income category of borrower	Differentiate maturity premium by income category of borrower	• Volume of expected PBAS resources for high-income countries: zero. Ordinary-term borrowers: US$900 million, of which US$600 million goes to LMICs and middle-income countries • Provides flexibility and choice to borrowers • Simplifies debt management due to harmonization with IBRD.

D. Highly concessional and blend term loans: Introduction of currency-specific service charge interest rates

17. Borrowing in a single currency reduces currency exposure for borrowers, especially those with revenues in a related currency or with local currencies pegged to one of the currencies of choice. This provides opportunities for borrowers to match the currency of revenue with debt, diversify currency risk and strengthen the financial management of debt portfolios.

18. In 2016, IFAD launched an initial pilot of its single-currency lending framework,[13] permitting borrowers, at their request, to denominate financing in United States dollars and euros as an alternative to special drawing rights (SDRs). Presently, the PCIF refers only to SDR and not to EUR or US$ as a denomination currency for highly concessional and blend financing. Therefore, an update will be made to reflect the single currency framework. IFAD currently offers the same pricing for its highly concessional and blend financing irrespective of currency. It is evident that a loan denominated in US$ needs to have a different market cost than a loan in SDR or in EUR; this differentiation is practised by all other IFIs. Management proposes to set the pricing of single currency-denominated loans on a financial equivalence basis so that at the time of price setting, the borrower will be financially indifferent to the denomination currency of the loan. This is the case whether a loan is in SDR or any of the single currency options offered (i.e. the expected cost of servicing the loan would be the same regardless of currency). Thus, the borrower can choose the option that is in line with its own debt-management strategy.

> Box 3
> **Single-currency lending on highly concessional terms**
>
> IFAD's Executive Board approved a loan to Pakistan for the National Poverty Graduation Programme. This US$82.6 million in financing was provided on highly concessional terms with a 0.75 per cent service charge per annum. If IFAD had introduced a financial equivalent adjustment, the applicable service charge would have been 1.44 per cent based on IDA rates. This difference would result in significant loss of reflows over time, which would be amplified if the demand for single-currency lending was sustained.

[13] The pilot facility comprised US$200 million. Demand for this facility far exceeded expectations, with US$1.3 billion committed in United States dollars and euros out of the US$1.9 billion available in 2016 and 2017.

Table 3
Introduction of currency-specific interest rates

Financing terms	*Current position*	*Change description*	*Considerations*
Highly concessional and blend	Use of SDR pricing also for US$ and euro financing	Introduction of basic adjustment to ensure financial equivalence between currencies of loans based on IDA rates.	• Volume of PBAS resources expected in non-SDR currency for these financing terms: US$958 million • Borrowers can choose loan currency and associated service/interest charge, permitting enhanced debt management including currency planning and mitigation of exchange rate volatility • Mismatch in IFAD's asset liability management (ALM) framework resolved

E. Highly concessional term loans: Differentiated pricing for small states economies

19. During the IFAD11 Consultation, Members requested that IFAD provide further incentives for small states economies. The small states economies exemption introduced to the PCIF in February 2018 allows additional concessionality for these countries in determining lending terms. IFAD proposes to provide further concessionality to these countries, allowing borrowers to repay less of the loan principal in earlier years by changing the amortization period from straight line (3.33 per cent) to 2 per cent per annum from years 11 to 20 and 4 per cent per annum from years 21 to 40. This will align IFAD's pricing for highly concessional loans with that of IDA (see annex III, section II).

Table 4
Small state economies

Financing terms	*Current position*	*Change description*	*Considerations*
Small states economies	Amortization period is straight line: 3.33 per cent per year	Amortization period to be 2 per cent for 11-20 years; and 4 per cent for 21-40 years	• Volume of expected PBAS resources: US$30 million • More favourable terms for borrowers • Negligible impact for IFAD

F. Highly concessional term loans: Change of concessionality

20. IFAD's commitment to address 90 per cent of its concessional resources to eligible low-income countries and LMICs constitutes one of the most important drivers for allocating resources through the approved IFAD11 PBAS formula. In addition, in 2018 IFAD introduced into the PCIF the concept of small states economies and their eligibility for highly concessional terms.

21. The terms for highly concessional loans in IFAD have remained unvaried since 1994: a maturity of 40 years including a 10-year grace period and 0.75 per cent service charge per annum. In terms of grant concessionality, IFAD has a 60 per cent grant element compared to 55 per cent for IDA's regular credits on SDR terms and 54 per cent for the African Development Fund (AfDF) "advance" subgroup of borrowers,[14] which represents nearly half the AfDF-only countries with a GNIpc of less than US$1,000. It is important to note that the "regular" subgroup of AfDF countries – which have a higher level of concessionality at 59 per cent, including a commitment fee – are wholly or partly eligible for the DSF based on the International Monetary Fund credit-worthiness assessment. Concessionality for Asian Development Bank (AsDB) concessional assistance project loans is 48 per cent.

22. In order to provide an overview of the development finance context in other institutions, a discussion took place in IDA's seventeenth replenishment (IDA17)

[14] These borrowers represent half of the AfDF-only countries with GNIpc of less than US$1,000 (with one exception).

with IDA's members to revise the future lending terms for its highly concessional term borrowers.[15] It was noted that a modest revision to reduce the level of concessionality for borrowers would result in an increase in IDA reflows. Similar reforms at AfDF took place to direct more resources to the poorest countries, differentiating hardened terms from the Thirteenth Replenishment of AfDF (ADF13). Taking these reforms into account, a simulation of external public and publicly guaranteed debt burden trajectories for IDA-only countries demonstrated that the revised IDA lending terms and other changes by IFIs were unlikely to have a material impact on a country's risk rating. As a result of these discussions, IDA's terms for its highly concessional instrument changed to a maturity of 38 years including a six-year grace period.

23. Management is proposing to adjust the overall concessionality of IFAD's highly concessional loans in line with those of other IFIs given the underlying parameters and risk-mitigation factors noted above. However, given the desire expressed by some borrowers to maintain a 10-year grace period and maturity of 40 years, it is proposed that concessionality be decreased by adjusting the amortization of the repayment period. The proposal is therefore to maintain the 40-year maturity period, including a 10-year grace period, but to modify the amortization of the repayment period to 4.5 per cent for years 11-30 and 1 per cent for years 31-40. Countries assessed as having high or moderate risk of debt distress ("red light" and "yellow light" countries) will continue to receive some or all of their financial assistance in the form of grants. A summary of the main terms and (current and proposed) level of concessionality for IFAD, IDA, AfDF and AsDB is detailed below:

Table 5
Concessionality and lending terms by IFI

	IDA	AfDF regular	AfDF advance	AsDF (concessional assistance only) project loans	AsDF (concessional assistance only) programme loans	IFAD current	IFAD proposal
Maturity (years)	38	40	40	32	24	40	40
Grace period (years)	6	10	5	8	8	10	10
Service charge SDR	0.75%	0.75%	0.75%	1% during grace period and 1.5% during amortisation period	1% during grace period and 1.5% during amortisation period	0.75%	0.75%
Commitment fee	0.00%	0.50%	0.50%	0.00%	0.00%	0.00%	0.00%
Repayment	3.125% years 7-38	2% years 11-20 4% years 21-40	2.9% years 11-40	4.167% years 9-32	6.25% years 9-24	3.33% years 11-40	4.5% years 11-30 1% years 30-40
Concessionality	**55%**	**62%**	**54%**	**48%**	**43%**	**60%**	**56%**

24. The small decrease in concessionality for highly concessional loans is expected to only marginally affect the external debt burden of the minority portion of IFAD's highly concessional term borrowers (just seven borrowers in IFAD11), which are not eligible for DSF grants. It will result in slightly improved financial sustainability for IFAD and – more importantly – the ability to increase internal resources for new commitments. The change ensures greater harmonization and comparability with IDA and AfDF, and increases IFAD's capacity to make new commitments to borrowers (see annex III, section III).

[15] The IDA discussion happened in the light of the: (i) progress made since the inception of the DSF, which provides grant financing for borrowers with moderate levels of debt distress and above; and (ii) level of concessionality for this product at a higher level than in other development organizations.

Table 6
Change of concessionality for highly concessional terms

Financing terms	*Current position*	*Change description*	*Considerations*
Highly concessional	Repayment period 3.33 per cent for years 11-40	Change in concessionality to approximately 55 per cent to reflect changes by IDA and AfDF. Repayment period 4.5 per cent for years 11-30 and 1 per cent for years 31-40	• Volume of expected PBAS resources: US$2 billion, of which two thirds allocated to DSF-eligible countries • Marginal negative impact on borrower concessionality but maintains long maturity and grace periods • Forecast positive impact of up to US$2 billion increase in liquidity over 50 years

G. All financing terms: Change in frequency of variable rate setting

25. IFAD sets its ordinary six-month floating term rates on a biannual basis and these rates remain effective for the entire six-month period. IFAD proposes to reset the six-month floating rate on a quarterly basis. Although less significant for ordinary term borrowers, for highly concessional and blend term borrowers that have rates fixed for the duration of their financing, more frequent rate setting will ensure that a more up-to-date market rate is used at the time of fixing. Both IBRD and IDA have set their six-month floating rates on a quarterly basis since 2017 (see annex V). This will require a change to the PCIF.

IV. Amendments to IFAD basic documents

26. The Agreement Establishing IFAD and the Policies and Criteria of IFAD Financing set out the roles and responsibilities of IFAD's governing bodies for policies governing financing by the Fund. "The Governing Council, while retaining its authority to establish the broad policies, criteria and regulations that govern financing by the Fund, acknowledges that the Executive Board has the primary responsibility to set out the detailed policies governing such financing…."[16]

27. Implementation of these proposed changes will require[17] an amendment to the PCIF for: (i) the introduction of differentiated maturity and grace periods for ordinary terms; (ii) the introduction of currency-specific loan pricing determined by the Executive Board for highly concessional and blend terms; and (iii) a change in frequency of the review and revision of the IFAD service charge, and the reference interest rate of rate setting.

28. In addition, a revision of IFAD's methodology will be needed to determine the applicable ordinary and intermediate interest rates charged to borrowers as approved by the Executive Board during its ninety-seventh and ninety-eighth sessions. These revisions will enable the introduction of: (i) a fixed spread and its related determination; (ii) maturity premium differentiation based on income category; and (iii) the differentiation of the amortization profile for highly concessional loans provided to small state economies and other eligible borrowers.

29. In the interests of consistency and to provide borrowers with additional options, it would be desirable for these changes to take place by the start of IFAD11. The preparation and presentation of this document have been timed with this objective. These changes should be effective from the date of the approval of the governing body without retroactive effect – i.e. Governing Council approval of the items in paragraph 27 and Executive Board approval of the proposals in paragraph 28. Financing already approved will continue to follow the established contractual terms and basis of pricing, including intermediate term loans.

[16] Para. 4 of the Policies and Criteria for IFAD Financing.
[17] A comparison table is attached in the appendix.

30. To enact these changes, negotiations for project financing taking place from 1 January until mid-February 2019 may need to contain conditionality to address the pending approval of the proposed PCIF amendments by the Governing Council.

V. Implementation: risk management, communication and administration

31. The financial scenarios used in this document have been calculated based on Management's best estimations under the current financial model; actual results may vary from those expected.

32. Due to the changes being proposed in this paper, there will be a need to update business processes such as loan administration, accounting and systems. A particular area of attention will be the downstream impact on IFAD's financial systems including the fair value impairment tool, the International Financial Reporting Standard 9 expected credit loss tool, and financial modelling reporting. IFAD will also adjust related procedures, manuals and processes for communication, administration and management, and ensure that internal and external capacities are built and maintained. The proposed changes will be integrated into the current transparency action plan in line with Management's commitments in document EB 2017/122/R.29/Rev.1 in order to make additional information on financing terms, rates and products available by the start of 2019.

33. The changes proposed above will be implemented through a roll out plan with dedicated internal and external communications. Capacities of staff and stakeholders will be strengthened to offer different options for borrowers and integrate more complex risk management and ALM. Management welcomes these changes as part of IFAD's developing financial architecture. Mitigating measures and safeguards include closer scrutiny of credit risk, creditor coordination and debt-mitigation policies such as the non-concessional borrowing policy.

VI. Conclusion and way forward

34. In the context of an increasingly complex development landscape and the shift from debt relief to debt management capacity, IFAD is acting on its IFAD11 commitments to operationalize the enhanced business model and develop its financial architecture. IFAD is providing concrete solutions to borrowers' requests for more flexibility and modernizing its financial product line. These solutions provide borrowers and IFAD with improved risk-mitigation possibilities, including enhanced debt management and reduced exposure to exchange rate volatility, improving IFAD's financial sustainability through faster reflows. By amending the PCIF, IFAD will ensure more consistent governance, which will increase its agility. The Fund's new vision of acting as an assembler of development financing will enhance its ability to meet borrowers' needs through greater harmonization with other IFIs, with the goal of helping borrowers achieve the Sustainable Development Goals and the 2030 Agenda.

35. This document was presented for review by the Audit Committee and Executive Board in September 2018. An updated document was then presented in November 2018 to the Audit Committee for review and is now being submitted to the Executive Board in December 2018 for approval. A draft resolution on the required amendments to the PCIF was submitted to the Audit Committee in November for review and to the Board at its December session for approval to transmit it to the Governing Council in February 2019.

36. IFAD Management plans to propose systematic updates along with new instruments and products in order to respond better to borrowers' requests and adapt to IFAD's evolving financial architecture.

Summary of proposed changes

Note: Annexes II and III include additional financial analysis based on the underlying assumptions indicated in these annexes.

Table 1
Ordinary term loans

<table>
<tr><th>Area of change</th><th>Current</th><th>Change description</th><th>Considerations</th><th>Annex reference</th></tr>
<tr><td rowspan="2">Increase options for grace and maturity period of variable spread</td><td>Maturity period up to 18 years, grace period pegged to 3 years</td><td>Offer final maturity periods up to 35 years and final average maturity period of 20 years. Maximum grace period of 10 years.</td><td rowspan="3">• Volume of expected performance-based allocation system (PBAS) resources: US$900 million
• Flexibility for borrowers to enhance debt-management strategies
• No significant overall financial impact for IFAD; slightly lower income expected on variable spread if borrowers take loans with similar characteristics to current loans, offset by slightly higher income on fixed spreads
• Increase in risk with a fixed spread
• Depending on demand for fixed spread loans, this could result in US$700 million in additional liquidity over 50 years</td><td rowspan="2">II
(section II)</td></tr>
<tr><td>No differentiation in pricing (only one price offered)</td><td>Introduce pricing according to average maturity buckets of IBRD.</td></tr>
<tr><td>Introduce fixed spread with options for grace and maturity period</td><td>No fixed spread offered</td><td>Introduce fixed spread with options for grace/maturity period, and introduce pricing according to IBRD average maturity bucket.</td><td>II
(section III)</td></tr>
<tr><td>Introduce maturity premium differentiation between income categories in countries</td><td>No differentiation by income category of borrower</td><td>Differentiate maturity premium by income category of borrower.</td><td>• Volume of expected PBAS resources: US$900 million (zero for high-income countries)
• Reduces the premiums for LMICs and middle-income countries (about US$672 million of IFAD11 allocations) in line with the range of increases recently implemented by IBRD
• Borrowers maintain flexibility and options for all maturity periods, and can choose shortened maturities for price reasons</td><td>II
(section IV)</td></tr>
</table>

Table 2
Highly concessional term loans

Area of change	*Current*	*Change description*	*Considerations*	*Annex reference*
All highly concessional terms				
Match pricing to currency denomination of financing	Fixed service charge for all currencies	Introduce basic adjustment to ensure financial equivalence between currency of financing based on IDA rates.	• Volume of expected PBAS resources: US$704 million • Borrowers can choose financing currency and associated service charge, permitting enhanced debt management, including currency planning and mitigation of exchange rate volatility • Mismatch in IFAD's ALM framework resolved	III (section IV)
Small state economies				
Defer amortization period	Amortization: Straight line 3.33 per cent	Amortization: 2 per cent for years 11-20 and 4 per cent for years 21-40.	• Volume of expected PBAS resources: US$30 million • More favourable terms for borrowers • Negligible impact for IFAD	III (section II)
Regular highly concessional terms				
Change in concessionality in line with IDA and regional development banks	Amortization: Straight line 3.33 per cent	Change in concessionality in line with IDA and AfDF. Repayment period 4.5 per cent years 11-30, 1 per cent years 31-40.	• Volume of expected PBAS resources: US$2 billion of which two thirds eligible for DSF • Marginal negative impact on borrowers affected in terms of concessionality but maintains long maturity and grace periods • Forecast positive impact of up to US$2 billion increase in liquidity over 50 years	III (section III)

Table 3
Blend term terms

Area of change	*Current*	*Change description*	*Considerations*	*Annex reference*
Match pricing to currency denomination of loan	Fixed interest rate for all currencies	Introduce basic adjustment to ensure financial equivalence between currency of loans based on IDA rates.	• Volume of expected PBAS resources: US$254 million • Borrowers can choose loan currency and associated interest charge, permitting enhanced debt management, including currency planning and mitigation of exchange rate volatility • Mismatch in IFAD's ALM framework resolved	IV

Table 4
All financing terms

Area of change	*Current*	*Change description*	*Considerations*	*Annex reference*
Periodicity of setting IFAD reference rates for the following period on the basis of market rates	Semi-annually	Quarterly	• Ensures fair pricing for loans on highly concessional and blend terms denominated in currency different than SDR by considering an interest rate valid during the quarter in which the signing date falls	V

Ordinary term loans: Overview and proposed changes

I. Overview of IFAD's current offer of financial products

1. The pricing of loans granted on ordinary terms is based on a floating reference rate, which in the case of United States dollars comprises the six-month LIBOR[18] plus a variable spread determined semi-annually by the Executive Board. The maturity period is 15 to 18 years, including a grace period of three years starting once the specified disbursement conditions have been met. The grace period may be extended to six years provided that the net present value principle is maintained.

2. The variable spread corresponds to the International Bank for Reconstruction and Development (IBRD) variable spread for the highest average maturity bucket – currently greater than 18 to 20 years – and has been used as a proxy for IFAD's cost of capital. It is important to note that this spread is not based on financial considerations linked to the specificity of IFAD's cost of capital, and is not directly linked to the average maturity of IFAD's non-concessional lending portfolio.

II. Variable spread price differentiation based on maturity bucket

3. It is proposed that variable maturity and grace periods be introduced as well as differentiated pricing depending on the maturity period of ordinary term loans with variable spreads. As a result, borrowers would have increased flexibility in determining maturity and grace periods, with a cap of 35 years on the final maturity, 20 years on the average maturity period and maximum grace period of 10 years. This offer will align IFAD with IBRD's offer and enhance the comparability of IFAD's financing terms. By introducing these options, the principles determining IFAD's reference interest rate will remain the same as IBRD's variable spread for each related maturity bucket.

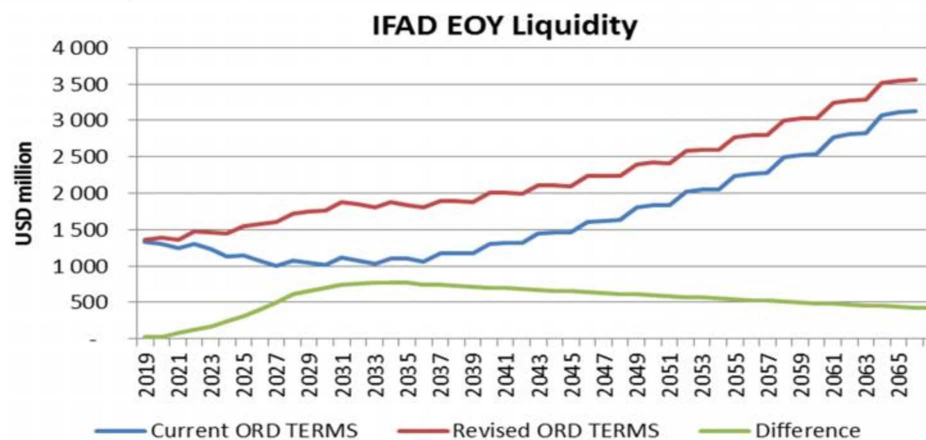
4. Borrowers have started to use more complex strategies in their financing, including those for: increasing the use of strategic benchmarks; specific targets for the currency mix; the share of fixed rate versus floating rate debt; and targets for amortization and maturity profiles for debt. Out of 23 borrowers eligible for ordinary terms in the Eleventh Replenishment of IFAD's Resources (IFAD11), 18 have formally requested that IFAD extend its offer of ordinary terms and adjust the interest rate charged to the selected average maturity. Despite the fact that IFAD does not apply commitment fees or upfront fees to undisbursed amounts, IFAD's offer is still considered by borrowers to be limited.

5. The Corporate-level Evaluation of IFAD's Financial Architecture[19] revealed that government officials from countries borrowing on ordinary terms "stated that they appreciated the flexibility and choice offered by multilateral development banks and suggested that IFAD adopt a similar approach". Expanding IFAD's ordinary terms in variable spreads will allow borrowers to manage their national balance sheets better and implement enhanced risk-management strategies. It will also resolve the current mismatch between the fixed maturity bucket used for IFAD's loans (18-20 years) and the applicable interest rate used by IBRD, which dictates an average repayment maturity of 10-12 years for financing with the same characteristics.

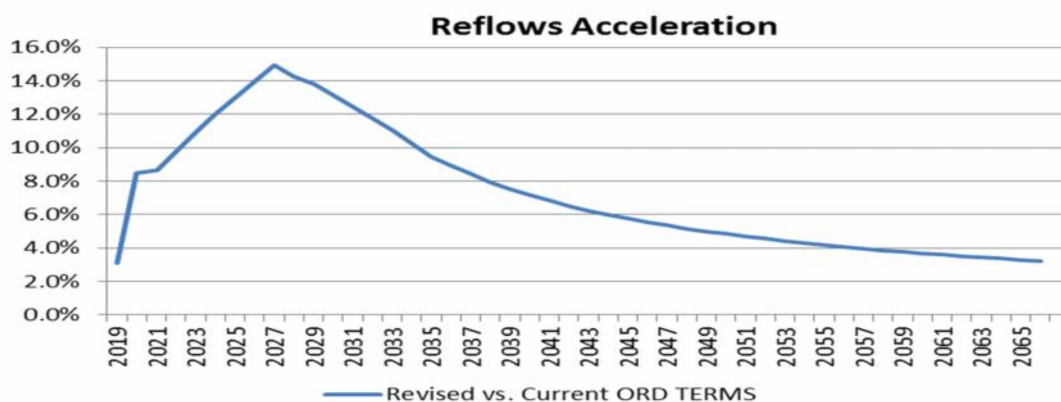
[18] The LIBOR is a floating interest rate at which banks can borrow unsecured funds from other banks in the London wholesale money market. Loans denominated in euros utilize Euro Interbank Offered Rate (EURIBOR) as the base lending rate, and those in SDR use composite rates derived from the SDR currencies.
[19] See EC 2018/101/W.P.5.

6. As a result of this change and based on the assumptions detailed in the footnote 19 below:[20]

   (i) The net impact on IFAD's overall liquidity will continue to be positive, with an expected US$500 million generated over the next 50 years. The annual additional liquidity will grow to US$800 million in IFAD17 and decrease thereafter (see graph below).



(ii) The shortened maturities will generate an acceleration in loan reflows from IFAD borrowers. As can be seen in the graph below, this acceleration will peak during the IFAD15 cycle. Reflows from ordinary term loans with shortened amortization profiles are paid 15 per cent faster than reflows under current terms.



[20] The unique IBRD maturity bucket used for IFAD's variable spread (maturity of 18 to 20 years) is adjusted to the specific currency of each loan. To simplify the assumption, the average of the United States dollar and euro spreads are used, resulting in a spread of 1.0575 per cent. The variable spread applied to IFAD loans as of 1 January 2018 is 0.96 per cent. The assumptions related to different buckets of spread determination for loans on ordinary terms are shown in the table below.

Loan terms	*Spread*	*Percentage weight in IFAD11 programme of loans and grants (PoLG)*	*Expected volume in IFAD11 PoLG (US$ million)*
Current	18+ to 20 year average	100	944
Potential change	Up to 8 year average	3	28
	8+ to 10 year average	3	31
	10+ to 12 year average	22	207
	12+ to 15 year average	22	205
	15+ to 18 year average	23	220
	18+ to 20 year average	27	253

III. Introduction of fixed spread option

7. IFAD proposes to introduce an additional offer for ordinary term borrowers with a fixed spread. The changes proposed in section II above would also apply to fixed spread loans; however the fixed spread would be determined at the time of the loan and fixed for the life of the loan based on the applicable spread on the day before signing.

8. IBRD introduced the fixed spread loan in 1999. This product offers borrowers a variable lending rate consisting of the six-month LIBOR and a fixed spread. The Asian Development Bank and African Development Bank introduced similar financing product characteristics in 2002 and 2005 respectively. All benchmarked international financial institutions (IFIs) apply a commitment fee and upfront fee to undisbursed amounts, which may be waived on a case-by-case basis. IFAD is not proposing to introduce similar fees.

9. Based on an analysis of potential demand from IFAD's borrowers at IBRD,[21] and in alignment with the forecast IFAD11 PoLG, US$233 million would be requested by borrowers on a fixed spread out of a total volume of US$944 million.

10. This additional offer is designed to respond to borrowers' requests for more flexible financial products. Fixed spread loans can be tailored to meet the needs of individual projects such as those with a dominant rural finance component (e.g. access to finance for poor rural groups). This type of project is becoming more prevalent in IFAD's global portfolio: 22 per cent of ordinary term loans during IFAD9 and IFAD10 financed project activities related to rural microfinance. Such an offer will allow borrowers to select the financing mechanism most suited to their economic situation, objectives and asset and liability management strategies. It will also enhance IFAD's reputation by offering a transparent basis for borrowers to compare IFAD's offer terms with those of other lenders.

11. In order to calculate the financial impact on IFAD, the simulation presented below for this offer assumes that 27 per cent of projected ordinary loans in IFAD11 could be offered at a fixed spread.[22] Currently, IFAD's variable spread follows a unique IBRD maturity bucket (maturity period of 18 to 20 years).[23]

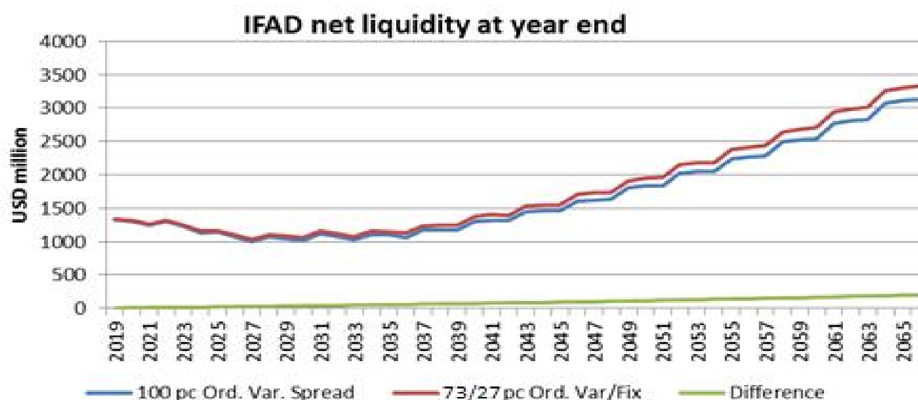
12. As a result of this change and based on assumptions in the footnote 23 below,[24] IFAD's financial sustainability will benefit from additional liquidity of US$7.5 million during IFAD11, growing to US$200 million over the next 16 replenishment cycles. This increase will be supported by the increase in spread for 50 per cent of ordinary term loans (US$168 million) and the investment return generated by the growing cumulative additional liquidity not used for additional approvals and disbursements of the PoLG.

[21] This analysis showed that, in fiscal year 2017: (i) seven countries borrowed all their loans on a fixed spread, for a total volume of US$3.1 billion; and (ii) another five borrowers received 53 per cent of their IBRD funding on a fixed spread, for a total volume of US$2.3 billion. In total 35.3 per cent of IBRD flexible loans to countries that are also IFAD borrowers were committed on a fixed spread. In addition, the analysis showed that agriculture-sector projects absorbed: 11 per cent of the total volume of loans for countries that borrowed only on a fixed spread; and 6 per cent of the total volume of IBRD resources allocated to a fixed spread.

[22] For an estimated 27 per cent of future loans approved, the model would apply a fixed spread of 1.0575 per cent (the variable spread applied on IFAD loans is 0.96 per cent was of 1 January 2018).

[23] To simplify the analysis, the average of US$ and EUR spreads was considered (i.e. a variable spread of 1.425 per cent).

[24] It is assumed that 27 per cent of projected ordinary loans in IFAD11 could be offered at a fixed spread, applying a fixed spread of 1.0575 per cent to 27 per cent of future loans approved (with a variable spread of 0.96 per cent as of 1 January 2018). IFAD's variable spread follows a unique IBRD maturity bucket (maturity period of 18 to 20 years). To simplify the analysis, the average of US$ and EUR spreads was considered (i.e. a variable spread of 1.425 per cent).



IV. Introduction of maturity premium differentiation between income categories of borrowers

13. The current methodology for determining IFAD's variable interest rate is pegged to the variable spread of IBRD loans with an average maturity of 18 to 20 years. This methodology includes a maturity premium.

14. During its spring meetings in 2018, the World Bank Group presented a new World capital package proposal.[25] One element in this package is the introduction of an increased maturity premium for loans signed from 1 July 2018, with a discount/surcharge to the maturity premium element of pricing based on GNIpc, as per the IBRD classification (the Atlas method). This includes a 10-40 basis point increase on the maturity premium for loans with an average maturity of more than 10 years. A discount has been proposed for countries with GNIpc lower than or equal to US$6,795[26] while a surcharge is proposed for countries with a GNIpc greater than US$12,055[27].

15. IFAD's methodology obliges the introduction of an increase in the maturity premium into its pricing. However, the current methodology does not include the concept of a discount/surcharge to the maturity premium element based on income level. As a result, IFAD's pricing will become increasingly more expensive for the majority of its ordinary terms borrowers and, in time, IFAD's terms will become increasingly diverse from comparable IFIs. Instead, approving the package of proposals and applying IBRD's maturity premium structure would allow borrowers to reduce the stress on their external debt burdens.

16. This measure, implemented by IBRD from 1 July 2018, introduces a 10-40 basis point increase on the maturity premium for loans with an average maturity longer than 10 years (e.g. 5-year grace, 15-year final maturity) as described in table 1. To adapt to the unique circumstances of different income groups, a discount of 5-20 basis points is proposed for countries with GNIpc lower than or equal to US$6,795, and a surcharge of 5-25 basis points is proposed for countries with GNIpc higher than US$12,055 (see table 2). It should be noted that the expected IFAD11 PoLG does not include a borrower to which this surcharge applies.

17. Exemptions from the price increase are also proposed for: (i) borrowers in transition from blend to ordinary terms; (ii) small states economies; (iii) countries assessed by IFAD to be in most-fragile situations according to the World Bank's

[25] World Bank, "Sustainable Financing for Sustainable Development: World Bank Group Capital Package Proposal", Development Committee (April 2018).

[26] For fiscal year 2019, this is the income threshold at which IBRD begins discussions with borrowers on graduating from IBRD lending

[27] For fiscal year 2019, the threshold for which countries are classified as high-income countries by the World Bank.

Harmonized list of Fragile Situations (in order to avoid further stress on external debt); and (iv) countries that transitioned to ordinary terms during IFAD9 and IFAD10, since applying the maturity premium increase would put additional stress on their external debt burdens (leading them to opt for financing on more competitive rates). The thresholds for these exemptions will be based on those of IBRD.

18. It is expected that changing to a higher income category will not impact the determination of the maturity premium differentiation for individual borrowers during an IFAD replenishment cycle. This will mirror the underlying principles for changes in financing terms, in which hardening of terms is established at the start of each replenishment cycle. However, changing to a lower income category or exempted category will become effective at the beginning of the next fiscal year. It is expected that this implementation arrangement will allow a smooth and predictable transition to less concessional IFAD pricing without significantly impacting IFAD's financial sustainability. Through this new mechanism, the classification of income category for each country will be formally revised once in each replenishment cycle. Reversals to a lower income category will continue to be applied on an annual basis.

19. While these changes will benefit all IFAD's borrowers, failing to introduce them can impact IFAD's competitiveness and capacity to deliver its IFAD11 PoLG to countries eligible for ordinary terms. In fact, IFAD could charge all its ordinary term borrowers a maturity premium of 90 basis points (as per the highest maturity bucket in table 1 below) regardless of their income and the loan maturity period.

Table 1
Proposed changes in maturity premium
(Source: World Bank Policy – Financial Terms and Conditions of Bank Financing, fiscal year 2019)

Average maturity bucket	*Current maturity premium*	*Proposed increase*	*Maturity premium after proposed increase*
Up to 8 year average	0	-	0
8+ to 10 year average	10	-	10
10+ to 12 year average	20	10	30
12+ to 15 year average	30	20	50
15+ to 18 year average	40	30	70
18+ to 20 year average	50	40	90

Table 2
Proposed discount/surcharge on IFAD loan pricing
(Source: World Bank Policy – Financial Terms and Conditions of Bank Financing, fiscal year 2019)

Average maturity bucket	*Basis point discount for countries with GNIpc lower than or equal US$6,795**	*Basis point surcharge for countries with GNIpc greater than US$12,055**
Up to 8 year average	0	+5
8+ to 10 year average	0	+5
10+ to 12 year average	-5	+10
12+ to 15 year average	-10	+15
15+ to 18 year average	-15	+20
18+ to 20 year average	-20	+25

* Subject to World Bank annual revision

20. Table 3 below provides an example of the different scenarios IFAD may face in determining its variable spread for loans signed from 1 January 2019 onwards. Considering a loan with an average maturity of 20 years, the variable spread will be equal to:

(i) 1.37 per cent if IFAD maintains the current methodology for establishing its variable spread by selecting the spread corresponding to the maturity bucket of 18 to 20 years as per IBRD;

(ii) 1.37 per cent if IFAD introduces the package proposed in this document, including differentiation of pricing by maturity bucket (as explained in section II); and

(iii) Between 0.97 per cent and 1.63 per cent if IFAD introduces maturity premium differentiation between income categories.

Table 3
Comparison of variable spread determination with the introduction of differentiation, based on maturity bucket and maturity premium differentiation between income categories (18-20 year maturity)

			Proposed changes			
Variable spread 1/7/2018 Maturity greater than 18 to 20 years/US$	*Current maturity 18-20 years*	*Proposed changes in maturity buckets without premium differentiation*	*Exemption* *Group A*	*GNI between US$1,165 and US$6,795* *Group B*	*GNI between US$6,795 and US$12,055* *Group C*	*GNIpc above US$12,055* *Group D*
Annual maturity premium	**0.90%**	**0.90%**	**0.50%**	**0.70%**	**0.90%**	**1.15%**
Contractual spread	0.50%					
Actual funding cost	-0.03%					
Final spread	**1.37%**	**1.37%**	**0.97%**	**1.17%**	**1.37%**	**1.63%**
Number of countries			6	10	6	0
Volume of expected IFAD11			US$323 million	US$303 million	US$259 million	0

21. Table 4 below provides an example of the different scenarios IFAD may face in determining its variable spread for loans signed from 1 January 2019 onwards. Considering a loan with an average maturity of 10 years, the variable spread will be equal to:

(i) 1.37 per cent if IFAD maintains its current methodology for establishing its variable spread by selecting the spread corresponding to the bucket of 18-20 years as per IBRD;

(ii) 0.77 per cent if IFAD introduces the proposal contained in this document, including differentiation of pricing by maturity bucket (as explained in section II); and

(iii) Between 0.67 per cent and 0.87 per cent if IFAD introduces maturity premium differentiation between income categories.

Table 4
Comparison of variable spread determination with the introduction of the differentiation, based on maturity bucket and maturity premium differentiation between income categories (10-12 year maturity)

			Proposed changes			
Variable spread 1/7/2018 Maturity greater than 10 to 12 years/US$	*Current maturity 18-20 years*	*Proposed changes in maturity buckets without premium differentiation*	*Exemption* *Group A*	*GNI between US$1,165 and US$6,795* *Group B*	*GNI between US$6,795 and US$12,055* *Group C*	*GNI above US$12,055* *Group D*
Annual maturity premium	**0.90%**	**0.30%**	**0.20%**	**0.25%**	**0.30%**	**0.40%**
Contractual spread	0.50%					
Actual funding cost	-0.03%					
Final spread	**1.37%**	**0.77%**	**0.67%**	**0.72%**	**0.77%**	**0.87%**

Number of countries	6	10	6	0
Volume of expected IFAD11	US$323 million	US$303 million	US$259 million	0

Highly concessional loans: Overview and proposed changes

I. Overview of current IFAD offer

1. The Policies and Criteria for IFAD Financing (PCIF) state that IFAD offers loans on highly concessional terms, which include an exemption for small states economies. These loans are interest free. A service charge of 0.75 per cent per year and a maturity period of 40 years, including a grace period of 10 years are applied starting from the date of approval by the Executive Board. The repayment profile is a straight line annual amortization of 3.33 per cent.

2. Although IFAD introduced the concept of small states economies in the PCIF and related lending terms in February 2018, its financing terms were not differentiated from those for regular highly concessional loans.

3. In terms of grant concessionality, a comparison between the highly concessional terms of IFAD and the International Development Association (IDA) shows a variation according to the currency denomination. IFAD has a 60 per cent grant element compared with IDA's 55 per cent grant element for regular credits on special drawing right (SDR) terms. This is because IFAD's financing terms have a maturity period of 40 years, including a 10-year grace period, compared with IDA's 38-year maturity period and six-year grace period. IFAD's terms are not differentiated by currency.

II. Small states economies: Differentiation of the amortization profile

4. Small states economies[28] "rely on international finance to supplement their fiscal envelopes. However, unless they have commodity exports or a service sector geared to the external market, many small states are not sufficiently creditworthy to raise funds in international capital markets. The local financial sector is similarly less developed, given diseconomies of scale. Several small states are forced to rely on concessional finance; others have significant debt as they draw on their natural resources to graduate from low-income status and lose their access to concessional financing."[29]

5. Considering the need to develop innovative solutions for addressing fragility, IFAD proposes to provide highly concessional resources with a maturity period of 40 years, including a grace period of 10 years, and a variable repayment profile of 2 per cent for years 11-20 and 4 per cent for years 21-40(see section III.E of the main report).

6. This adjustment will assist small states economies in managing their debt and securing the repayment of contracted debt over a longer period of time. It will also benefit IFAD through harmonization with other IFIs (IDA introduced a similar offer during its eighteenth replenishment [IDA18]) and tailor financing terms to borrowers' financial situations.

7. To calculate the financial impact on IFAD, the simulation presented below assumes that the volume of the programme of loans and grants (PoLG) for the Eleventh Replenishment of IFAD's Resources (IFAD11) allocated to small states on highly concessional terms is approximately US$30 million.

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[28] The World Bank Group defines small states economies as countries that: (a) have a population of 1.5 million or less; or (b) are members of the Small States Forum. See http://pubdocs.worldbank.org/en/244361475521083722/Small-States-Stocktaking-2016.pdf.

[29] The World Bank in Small States – overview (www.worldbank.org/en/country/smallstates/overview#1).

8. As a result of this change, it is expected that:

- Reflows will be lower during years 11 to 20 while there will be an increase in reflows during years 21 to 40. The overall slowdown in the extended repayment profile for US$30 million in IFAD11 is negligible.
- IFAD's grant element and concessionality for small states economies will increase to match the IDA level of 63 per cent.

III. Regular highly concessional loans: change in concessionality

9. IFAD would introduce a differentiation of concessionality into its highly concessional offer, but would retain its current long maturity and grace periods, which borrowers have indicated are appreciated. The reduction in concessionality would be obtained by adjusting the amortization of the repayment period to 4.5 per cent in years 11 to 30 and 1 per cent thereafter.

10. This proposed change was driven by the need to differentiate highly concessional lending terms based on borrowers' economic capacity – with the most concessional terms targeted to the most vulnerable countries based on an annual debt sustainability assessment and Debt Sustainability Framework eligibility. The introduction in February 2018 of the concept of small states economies for determining lending terms was another action by IFAD to increase flexibility.

11. During IDA17, IDA's members agreed to change the maturity and grace period profile for IDA regular loans by moving from a maturity period of 40 years, including a grace period of 10 years, to a maturity period of 38 years, including a grace period of six years. The amortization profile has remained equivalent to a straight line annual amortization of 3.125 per cent.

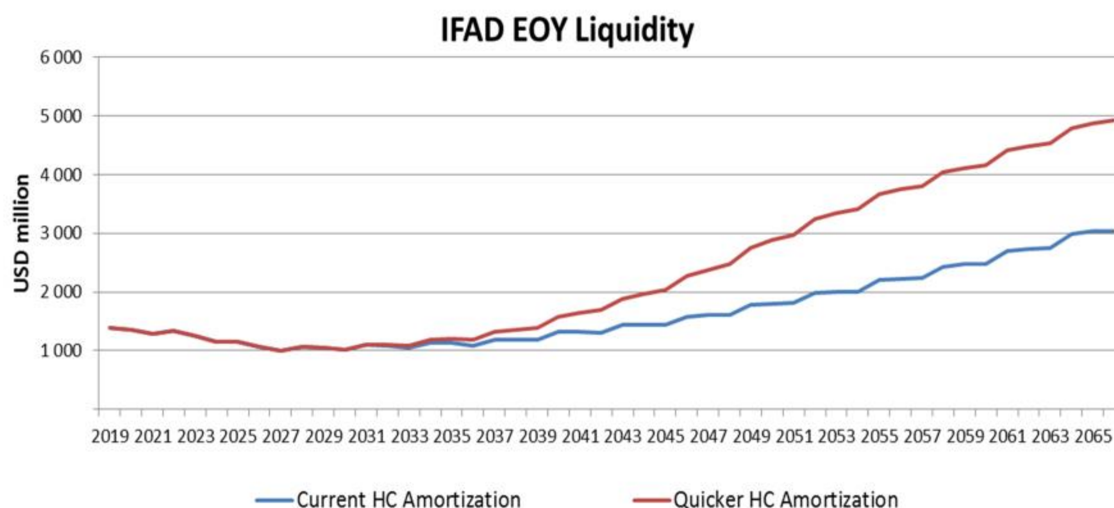
12. The African Development Fund (AfDF) also introduced hardened terms during its thirteenth replenishment to decrease the concessionality of its comparable product to a similar level.

13. The Asian Development Bank has a relatively lower degree of concessionality for its concessional assistance loans: 43 per cent to 48 per cent according to project type.

14. A modest revision of lending on regular highly concessional terms would slightly accelerate loan reflows, resulting in a stronger liquidity position and increasing the internal resources available for new commitments. At the same time, it would maintain a high degree of concessionality with a grant element of approximately 56 per cent. For IFAD11, an estimated volume of US$1.1 billion will be allocated on highly concessional terms, representing 29 per cent of the total PoLG and the largest portion of IFAD11 resources.

15. As a result of the change, it is expected that:

- Quicker amortization will generate an acceleration in loan reflow payments from IFAD borrowers, resulting in a stronger liquidity position over 50 years – exceeding US$2 billion – as shown in the chart below.
- The interest rate applied to smaller outstanding balances will generate a loss of loan income, which will be compensated by the increase in investment income. The overall impact on net income over 50 years will be negligible.
- IFAD's grant element and concessionality will decrease to a level slightly higher than that of IDA and AfDF.



IV. Introduction of currency-specific service charge pricing

16. The effect of borrowing in a single currency and the history of IFAD's single-currency lending framework are described in section III.D of the main report. The total volume committed on highly concessional terms from September 2016 to April 2018 was equivalent to US$400 million.

17. Given this trajectory and continued demand, which is expected to reach US$700 million, IFAD proposes the introduction of a basic adjustment for differences in notional rates between currencies on a financial equivalent basis (i.e. currency-specific loan pricing). In this scenario, at the time of setting the pricing, the borrower would be financially indifferent to the denomination of the loan – whether it is in SDR or any of other single currency.

18. Presently, the PCIF refers only to SDR as a denomination currency for highly concessional financing. Therefore, an update will be made to reflect the single currency framework.

Table 1
Comparison of service charges between IFAD loans and IDA credits on highly concessional terms (effective 1 July 2018)

Service charge	*SDR %*	*US$ %*	*EUR %*
Current IFAD (40 year with 10 year grace period)	0.75	0.75	0.75
IDA small states economy (40 year with 10 year grace period)	0.75	1.37	0.75
IDA regular credit for IDA only (38 year with 6 year grace period)	0.75	1.41	0.75

Blend term loans: Overview and proposed changes

I. Introduction of currency-specific service charge and interest pricing

1. The background to this annex is similar to that of annex III, section IV, except that the volumes committed from September 2016 to April 2018 on blend terms were equivalent to US$400 million. The projected volume for the Eleventh Replenishment of IFAD's Resources is approximately US$300 million.

Table 1
Comparison of interest rates and service charges between IFAD loans and International Development Association (IDA) credits on blend terms (effective 1 July 2018)

Service charge	*SDR %*	*US$ %*	*EUR %*
Current IFAD (25 year with 5 year grace period)	2.00	2.00	2.00
IDA (30 year with 5 year grace period)	2.00	2.86	1.38

2. The Policies and Criteria for IFAD Financing currently refers only to special drawing rights as a denomination currency for blend financing. Therefore an update will be needed to reflect the single currency framework.

IFAD reference rate frequency setting: Proposed changes

1. At its ninety-seventh and ninety-eighth sessions in September and December 2009, the Executive Board approved the current IFAD methodology used to determine the applicable interest rate for loans on ordinary and intermediate[30] terms. The interest rate that IFAD charges its borrowers is determined and updated by IFAD at six-monthly intervals. In addition to the weighted LIBOR interest rate (for special drawing right [SDR] loans) and Euro Interbank Offered Rate (EURIBOR) (for euro-denominated loans), a spread component derived from the International Bank for Reconstruction and Development (IBRD) is also applied to determine the final interest rate charged. This methodology was adopted to align IFAD's practices with those applied by other international financial institutions (IFIs).

2. Presently, IFAD's pricing of ordinary and intermediate loans is based on a floating reference rate calculated biannually based on the six-month LIBOR/EURIBOR plus a variable spread. The current mechanism involves the following:

   - For loans on ordinary and intermediate variable terms denominated in SDR, the applicable rate is based on the SDR LIBOR six-month variable rate in force on the first working day of the six-month period, plus the above-mentioned IBRD SDR spread (variable rate/variable spread loans).
   - For loans on ordinary and intermediate variable terms denominated in United States dollars, the applicable rate is based on the LIBOR six-month variable rate in force on the first working day of the six-month period, plus the IBRD United States dollar spread (variable rate/variable spread loans).
   - For loans on ordinary and intermediate variable terms denominated in euros, the applicable rate is based on the EURIBOR six-month variable rate in force on the first working day of the six-monthly period, plus the IBRD euro spread (variable rate/variable spread loans).
   - When any LIBOR/EURIBOR rate has a negative value, it will be deemed to have a value of zero for the purpose of calculating IFAD's variable interest rate (this feature was adopted by the Executive Board in September 2016).[31]

3. Both IBRD and IDA have set their rates on a quarterly basis since 2017. IFAD sets its ordinary term rates on a six monthly basis. Although this is not significant for ordinary term borrowers, for highly concessional and blend term borrowers (which have rates fixed for the duration of the financing), more frequent rate setting will ensure that an up-to-date market rate is used at the time of fixing.

4. The Policies and Criteria for IFAD Financing currently refers to biannual frequency to determine IFAD's reference rate. Therefore an update will be needed to reflect the proposed change to quarterly frequency.

[30] Intermediate variable: IFAD loans extended on intermediate terms (which have not been offered since 2010) shall have an annual interest rate equivalent to 50 per cent of the variable reference interest rate, as determined annually by the Executive Board, and a maturity period of 20 years, including a grace period of five years starting once disbursement conditions have been met.

[31] See EB 2016/118/R.28, IFAD's variable interest rate methodology: Impact of negative interest rates.

Draft resolution .../XLII

Revision of the Policies and Criteria for IFAD Financing

The Governing Council of IFAD,

Recalling resolution 178/XXXVI, in which it decided upon the proposal of the Executive Board to approve the Policies and Criteria for IFAD Financing;

Having reviewed the proposed revisions to the Policies and Criteria for IFAD Financing submitted by the Executive Board as contained in document GC 42/X;

Adopts the Policies and Criteria for IFAD Financing, as revised below, which shall take effect from the adoption of this resolution; and

Hereby decides:

1. Section I, paragraph 3 of the Policies is hereby amended to read as follows (added text is underlined):

    3. The Lending Policies and Criteria were amended by the Governing Council several times between 1994 and 1998, but the document was not updated or reviewed thereafter. In 2010, the Governing Council instructed the Executive Board to "submit to the thirty-fourth session of the Governing Council in 2011 revised Lending Policies and Criteria that shall take into account all developments since the last revision of the Lending Policies and Criteria in 1998 and express concisely and clearly the broad policies and criteria applicable to financing by the Fund." As a result, the Policies and Criteria for IFAD Financing were adopted by the Governing Council in February 2013. In 2018 and in 2019, the Policies and Criteria for IFAD Financing were amended to reflect changes required to give effect to the transition framework and to update the financing terms.

2. Section IV, paragraph 15(a)(iii)(1), (2) and (3) of the Policies are hereby amended to read as follows (added text is underlined and deleted text is shown in strikethrough):

    (1) ~~Special~~ Loans on highly concessional terms shall be free of interest but bear a service charge on the principal amount outstanding of three fourths of one per cent (0.75 per cent) per annum for loans expressed in SDR and as determined by the Executive Board for other currencies on a financial equivalence basis, and have a maturity period of forty (40) years (unless a shorter maturity is requested by the borrower), including a grace period of ten (10) years starting from the date of approval by the Executive Board;

    (2) Loans granted on blend terms shall be subject to ~~interest~~ a service charge on the principal amount outstanding ~~at a fixed rate of 1.25 per cent~~ of three fourths of one per cent (0.75 per cent) per annum for loans expressed in SDR and as determined by the Executive Board for other currencies on a financial equivalence basis, shall bear interest on the principal amount outstanding at a fixed rate of 1.25 per cent for loans expressed in SDR and as determined by the Executive Board for other currencies on a financial equivalence basis, and shall have a maturity period of twenty-five (25) years (unless a shorter maturity is requested by the borrower) including a grace period of five (5) years, ~~and in addition a service charge of 0.75 per cent,~~ starting from the date of approval by the Executive Board;

(3) Loans on ordinary terms shall ~~have a rate of interest per annum equivalent to one hundred per cent (100 per cent) of the variable reference interest rate~~ bear interest on the principal amount outstanding at the IFAD reference interest rate, as determined ~~annually~~ by the Executive Board in accordance with subparagraph (iv), and have a final maturity ~~period~~ limit ~~of fifteen (15) to eighteen (18) years, including a grace period of three (3) years~~ (unless a shorter maturity is requested by the borrower), of up to thirty-five (35) years and a final average maturity limit of up to twenty (20) years, starting from the date as of which the Fund has determined that all general conditions precedent to withdrawal have been fulfilled.

3. A new sub-paragraph – paragraph 15(a)(iv)(1) – is added and will read as follows:

(iv) The Executive Board shall:
(1) Determine the service charge and related interest applicable to loans on highly concessional terms and blend terms expressed in another unit of denomination other than SDR.

The following sub-paragraphs are renumbered accordingly (see below).

4. Renumbered sub-paragraphs (2) and (3) of paragraph 15(a)(iv) are hereby amended to read as follows (additional text is underlined and deleted text is struck through):

(iv) The Executive Board shall:

(2) Determine, on the basis of the variable ordinary interest rate of international financial institutions concerned with development, the method of calculation of the reference rate of interest (the IFAD reference interest rate) ~~for application in IFAD~~, which shall provide the basis for the review and revision prescribed in sub-paragraph (~~2~~ 3) below; and

(3) ~~Decide, annually, the rates of interest to be applied to loans on ordinary terms. For that purpose, it shall review annually the rates of interest applicable to loans on ordinary terms and revise such rates, if necessary, on the basis of the reference rate of interest in effect on 1 July of each year.~~ Every three months, review and revise the IFAD service charge and the reference interest rate for the following period on the basis of market rates.