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IFAD Credit Rating Assessment – Update on Process and Road Map

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Abbreviations and acronyms

CA	credit assessment
CLE	corporate-level evaluation
CRA	credit rating agency
DFI	development finance institution
IDA	International Development Association
MDB	multilateral development bank
MLI	multilateral lending institution
OSE	other supranational entity
PCT	preferred credit treatment
S&P	Standard & Poor's

IFAD Credit Rating Assessment – Update on Process and Road Map

I. Background

1. Member State contributions have been the bedrock of IFAD's capital since its inception. More recently, in response to an ever-growing programme of loans and grants (PoLG) – and an associated growth in financing needs – IFAD developed the Sovereign Borrowing Framework and the Concessional Partner Loan Framework with the purpose of fully integrating borrowing into its funding structure and financial profile.¹
2. During the IFAD11 Consultation, delegates "endorsed a road map for borrowing from the capital markets aimed at readying IFAD for possible market borrowing".² They also agreed for the Executive Board to be consulted during the process, including for approval to initiate the formal credit rating process.
3. Since then, Management has continued work on strengthening IFAD's financial architecture, equipping it with the appropriate risk management procedures and financial tools to support its current borrowing activities and to diversify its sources of funding. The strategy is to gradually and prudently increase the leverage ratio of the Fund through a combination of sovereign loans and – subject to the approval of the governing bodies – private and public issuance of bonds.
4. Two important independent reports have recently confirmed the need to reinforce financial and risk management, emanating from: the Corporate-level evaluation (CLE) on IFAD's Financial Architecture undertaken by the Independent Office of Evaluation of IFAD in mid-2018; and the External Independent Assessment of IFAD's Financial Risk Management conducted in the second half of 2018. Produced at the suggestion of Member States, these two important reports have provided useful indications in terms of the challenges posed by the current financial set up of IFAD and the steps needed to tackle them.
5. Both reports point to a credit rating as a means to strengthen IFAD's financial capability and a prerequisite for borrowing from the capital markets.³
6. The purpose of this paper is to share Management's findings based on the preparatory work done so far, the key elements considered by international rating agencies in their credit rating processes and a possible timeline for a formal credit rating assessment of IFAD.

¹ Borrowing has been considered an alternative source of funding since the Eighth Replenishment of IFAD's Resources (IFAD8), when the institution benefited from the Spanish Food Security Cofinancing Facility Trust Fund; borrowing was confirmed in IFAD9, IFAD10 and IFAD11 to bridge a shortfall in contributions against PoLG requirements.

² Report of the Consultation on the Eleventh Replenishment of IFAD's Resources, GC 41/L.3/Rev.1.

³ Recommendation 4 of the CLE includes the undertaking of preparatory work to obtain a rating for potential access to capital markets; the External Independent Assessment includes, as a preferable path, enhancing financial risk discipline to facilitate the obtaining of an external credit rating and provide wider funding options.

II. Credit rating process

A. Credit ratings and credit rating agencies

7. A credit rating (or simply “rating”) provides standard, widely recognized, independent and transparent information about the credit risk of a (rated) entity. A rating ranks a debtor’s ability to pay back debt by making timely principal and interest payments and its likelihood of default. As illustrated in table 1 below, the higher the rating, the lower the credit risk and the lower the likelihood of default, and vice versa.

Table 1
Comparative rating scales by credit rating agency

<i>Fitch</i>	<i>Standard & Poor's (S&P)</i>	<i>Moody's</i>	<i>Rating grade description (Moody's)</i>	
AAA	AAA	Aaa	Investment grade	Minimal credit risk
AA*	AA*	Aa1		Very low credit risk
AA	AA	Aa2		
AA-	AA-	Aa3		
A*	A*	A1		Low credit risk
A	A	A2		
A-	A-	A3		
BBB*	BBB*	Baa1	Moderate credit risk	
BBB	BBB	Baa2		
BBB-	BBB-	Baa3		
BB*	BB*	Ba1	Speculative grade	Substantial credit risk
BB	BB	Ba2		
BB-	BB-	Ba3		
B*	B*	B1		High credit risk
B	B	B2		
B-	B-	B3		
CCC*	CCC*	Caa1		Very high credit risk
CCC	CCC	Caa2		
CCC-	CCC-	Caa3		
CC	CC	Ca	In or near default. With possibility of recovery.	
C	C			
DDD	SD	C	In default, with little chance of recovery.	
DD	D			
D				

Source: Moody's.

8. Credit ratings are the most important tool for assessing the financial strength of an institution and the adequacy of its policies and governance structure.⁴ Credit rating agencies (CRAs) undertake very thorough due diligence and provide comparative results within different segments of an institution.
- ### B. Features of credit ratings for development finance institutions
9. Since 1947, when the International Bank for Reconstruction and Development obtained its first rating (AA by Fitch and A by S&P), development finance institutions (DFIs) have progressively acknowledged the importance of having a credit rating. Many institutions have transformed their financial architecture and initiated a credit rating process several years after their establishment to optimize their financial position, access capital markets and perform their public policy roles more effectively.
10. At present, 70 per cent of DFIs and other supranational organizations rated by the three main rating agencies (S&P, Moody's and Fitch) have a credit rating of between AA and AAA. This provides the most desirable minimum range of rating for DFIs to access a wide number of markets and investors, making them eligible

⁴ It noteworthy that IFAD's financial profile has already been assessed by some of its financial counterparties in the context of the IFAD's current borrowing and certain Treasury Services Division operations. However, the assessment methodologies used are not homogenous, unlike those of the rating agencies.

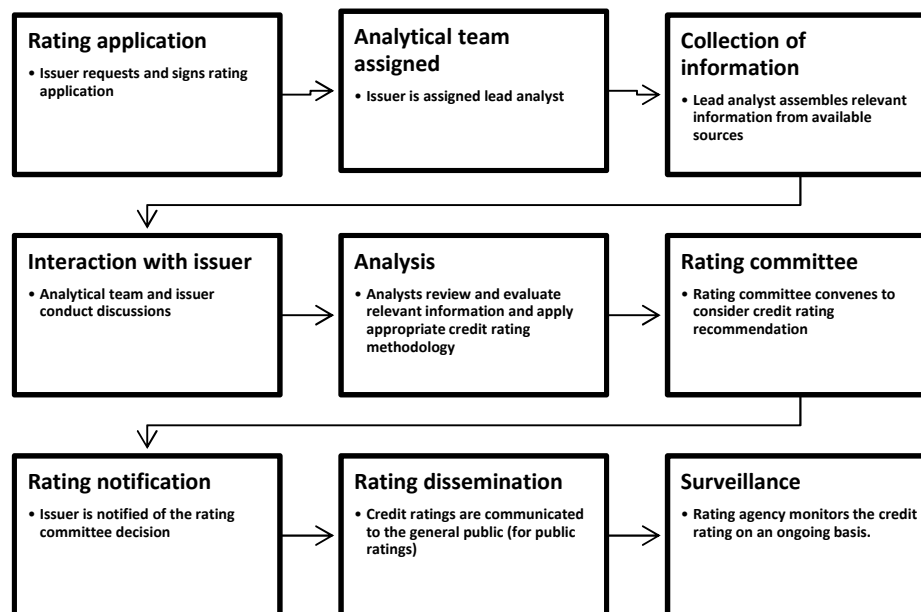
for many institutional counterparties, diversifying their funding sources and lowering the cost of their funds.

11. For DFIs, obtaining a credit rating is beneficial for the following reasons:
 - (i) CRAs apply a rigorous process in conducting their assessments, and their opinions are widely accepted in the financial markets;
 - (ii) As DFIs are not regulated, the independent, objective and credible opinions provided by CRAs become an important reference for the governance bodies and management of DFIs;
 - (iii) A credit rating assessment provides objective comparability among DFIs' financial practices;
 - (iv) The credit rating process creates incentives to enhance governance and financial policies, helping the DFI to raise its own standards and adopt industry best practices.
12. For an institution such as IFAD, a key feature of the credit rating process is that it will not be solely driven by Management. The support of Member States (both ongoing and extraordinary) and the interaction between the CRAs and Member State representatives during the process will be crucial for a positive outcome.
13. This key feature emerged clearly from the feedback received by IFAD Management regarding the recent rating of the International Development Association (IDA). Experience about the IDA rating process was shared at a workshop held at IFAD headquarters in September 2018 by a team from the World Bank Treasury; information was also gathered through various missions and bilateral conversations between IFAD Financial Operations Department staff and World Bank Group officers over the past 18 months.
14. The importance of Member State support was also clearly evident from an analysis of the credit rating opinions provided on various peer DFIs surveyed by IFAD Management, including the most recent examples of credit rating obtained by IDA and the Asian Infrastructure Investment Bank (both rated AAA).
15. Another important feature driving the credit ratings for DFIs is the phenomenon known as preferred credit treatment (PCT), an informal practice whereby distressed sovereign states service their obligations to some lenders (multilateral development banks [MDBs] and other DFIs) while defaulting on other debts.
16. PCT on sovereign exposures is a cornerstone of the DFI rating assessment. It is considered a multi-dimensional factor since it affects several elements included in rating methodologies of the CRAs, and is in some aspects quantified.
17. Even if it is acknowledged that IFAD enjoys PCT, as demonstrated by the strong track record of payments by its borrowing countries, this track record will be examined by rating agencies (and quantified as weak, adequate or strong) and the finding will prevail going forward due to its relevance in the credit rating assessment.

C. Process

18. For IFAD, the credit rating process could take approximately 12 months from the date of the rating application. The diagram below provides a snapshot of the various stages of the credit rating process.

Figure 1
Credit rating process



Source: Moody's, *Ratings Process: Moody's Process*.

D. Credit assessment

19. Credit ratings are either solicited or unsolicited, and can be private, shadow or public.⁵ Solicited ratings are initiated by an entity seeking a rating, as will be the case for IFAD. IFAD would engage the agency directly and agree in advance on the purpose and contents of the rating service and related fees. IFAD would then grant the agency access to Senior Management staff and non-publicly available information. Unsolicited ratings, in contrast, are initiated by the rating agency and based on publicly available information only.
20. An institution seeking to be rated can opt for an informal rating assessment or credit assessment (CA) as a stand-alone exercise or ahead of initiating a public rating process. As IFAD is considering obtaining a public rating entailing a full, interactive rating analysis, it may have reservations about the process involved and whether the ultimate result will meet its needs. Some institutions might be concerned about the amount of Management time needed for a full rating analysis, the cost to be sustained or the likelihood of their achieving a rating grade that they perceive as "acceptable". A CA gives the opportunity to examine credit strength without committing to the more resource-intensive full rating analysis. The process may help Management identify strategic issues ahead of the public rating process and have an opinion regarding the impact on the rating of different financial scenarios. If the CA level is acceptable to Management (i.e. a strong rating evaluation), a more detailed, public rating analysis can be completed shortly thereafter.
21. A CA is not a credit rating. It is an indicator of the rating agency's opinion of creditworthiness that may be expressed in descriptive terms, or as a broad rating

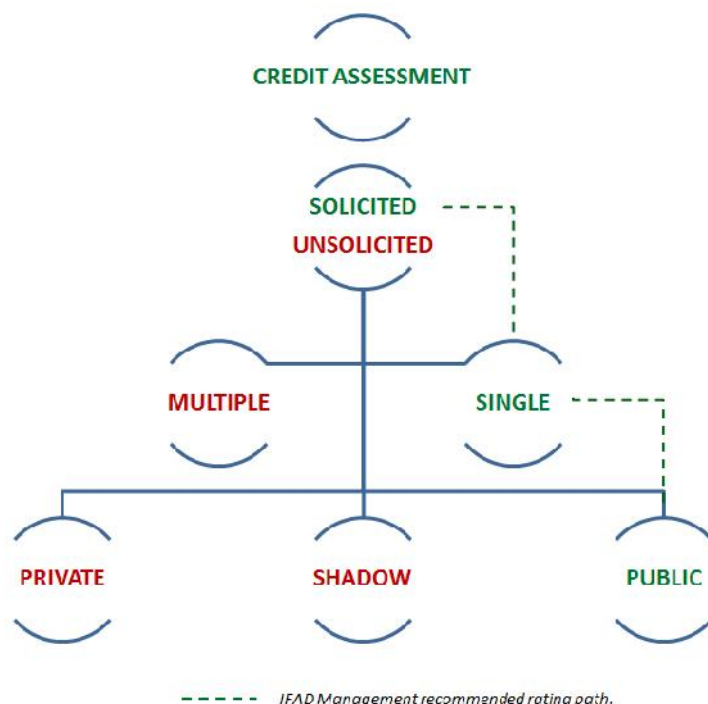
⁵ Private ratings are issued for entities with no publicly traded debt or where the rating is required for internal benchmarking. It cannot be publicly disseminated. A shadow rating, however, is a (eventually) publicly disseminated rating, temporarily provided only to the bond issuer. It cannot be withheld by the issuer. Finally, a public rating is generally provided to entities that will issue publicly traded debt. Once privately communicated to the prospective issuer, it can be withheld by the issuer before publication.

category, or with the addition of a plus (+) or minus (-) sign to indicate relative strength within the category. It reflects the agency's view of the general credit strengths and weaknesses of the entity seeking a rating. It may also pertain to limited credit matters or carve out certain elements that would ordinarily be taken into account in a credit rating.

22. A CA usually entails a point-in-time evaluation (i.e. ongoing surveillance or updates are not necessary), and it is a confidential process. Credit assessments are expressed using the traditional credit rating symbols, but in lower case (e.g. "aaa").⁶

Figure 2

Overview of different rating options



23. As shown in the annex, IFAD will pursue a CA in the third quarter of 2019 in order to gain valuable information in preparation for the ensuing formal public rating process. It may opt to engage just one CRA.⁷

E. Additional parties involved

24. During the rating process, institutions usually opt to avail themselves of the support of a rating advisor. The role of the advisor is to assist the institutions in preparing material for communication and the elaboration of the credit story of the institution throughout the process.
25. The rating advisor can bring to the table the experience gained in assisting other peer entities in the rating effort and can often provide significant value added. This role is usually covered by a private sector entity such as an investment bank and is generally provided free of charge.⁸

⁶ Source: Standard & Poor's, Global Ratings, Product & Capabilities, Credit Assessments.

⁷ Ratings can be sought from multiple CRAs, either simultaneously or at different times. The cheapest option in terms of rating cost is to request one rating by a single CRA from the "big three". The multiple rating option combines two or more ratings. The advantage of this alternative versus the single-rating option is that it is derived from a combination of multiple rating methodologies that are adopted by different agencies to arrive at their final rating. As the approach of CRAs differ slightly in certain areas of their analysis, which sometimes translates into a split rating, opting for multiple ratings will send a reinforced message to investors about the credit standing of the rated entity.

⁸ An investment bank generally provides the rating advisory service free of charge. However, it is accepted practice that the initial free service is paid upon engagement of that bank for the roles of arranger and/or lead manager of the ensuing bond programme and inaugural bond issue.

26. IFAD is maintaining an open dialogue with the World Bank on this topic with a view to benefitting from the many lessons learned during the IDA rating process.

III. Different rating methodologies

27. Although the rating scales and the implication of the exercise for the rated entity are easily comparable across the main rating agencies, CRAs do not follow exactly the same methodology to evaluate an institution's credit standing. Rather, they focus on different factors to come to their final decision. CRAs issue and update their methodologies regularly for assessing DFIs in order to provide a transparent picture of the main factors considered in the rating process.
28. Table 2 below summarizes the key features of the rating assessment of each CRA. A detailed description is provided in the following paragraphs. At the appropriate time, IFAD will have to make the choice to apply for single or multiple ratings.

Table 2
Key features for assessing credit ratings of DFIs

<i>Standard & Poor's</i>	<i>Moody's</i>	<i>Fitch</i>
Capital adequacy	Capital adequacy	Solvency
Liquidity and funding	Liquidity and funding	Liquidity
Policy importance	Adjustment factors: operating environment and quality of management	Business environment
Governance and management expertise		
Extraordinary shareholder support	Strength of member support	Extraordinary support

A. Standard and Poor's

29. In December 2018, S&P released its revised methodology for multilateral lending institutions (MLIs). Similar to the other agencies, S&P's ratings are based on multiple ratings (credit profiles) that progressively interact to conclude with a final rating.
30. S&P first provides an indicative stand-alone credit profile (SACP), which is based on the assessment of two broad factors:
- (i) The enterprise risk profile, composed of the analysis of the MLI's policy importance, and its governance and management expertise; and
 - (ii) The financial risk profile, which includes the assessment of capitalization and the funding and liquidity profile.
31. One of the most quantitative factors used by S&P is the evaluation of capitalization, which is derived from the risk-adjusted capital ratio. This ratio is the same as that applied to commercial banks (in sum, the relation of capital resources and risk weighted assets), adjusted for specific attributes of MLIs, namely the preferred credit treatment, diversification and concentration.
32. Once it has assessed the SACP, S&P assesses the likelihood of the institution receiving extraordinary support to service its debt obligations. Importantly, S&P makes the distinction between MLIs and multilateral aid agencies; for the latter, the agency assesses the support offered by multi-year sovereign commitments to fund the operations.

B. Moody's

33. Moody's assessment of supranational institutions covers the MDBs and other supranational entities (OSEs). On the one side, Moody's defines an MDB as a financial institution that is principally owned jointly, directly or indirectly, by a group of sovereign governments, is legally distinct from its member governments and has a public policy mandate. Like MDBs, OSEs are entities that are owned by two or more sovereign governments and have a public policy mandate. However, Moody's understands that OSEs generally have little or no capital to support

ongoing operations, and that they typically have a narrower mandate than MDBs, which does not necessarily target development.

34. According to the latest preliminary review of Moody's methodology (January 2019),⁹ the intrinsic financial strength is determined by the following factors:
- (i) Capital adequacy, which assesses the degree to which an institution is leveraged, credit quality of its development assets and asset performance;
 - (ii) Liquidity and funding, which assesses the availability of liquid resources and the quality and structure of the funding;
 - (iii) Operating environment and quality of risk management, as adjustment factors; and
 - (iv) Shareholders' ability and willingness to support the institution.
35. Of the factors above-mentioned, capitalization and liquidity are critical to assess the preliminary intrinsic financial strength (intrinsic rating). Capital adequacy is a key indicator of the institution's capacity to absorb credit or market losses from its operations, which given the mandate, are typically concentrated in risky sectors or regions. Liquidity is also an important factor to assess the institution's ability to meet its obligations; this is particularly important for DFIs, which, in contrast to commercial financial institutions, do not have deposits. The combination of these two broad factors (with equal weight given to each) will constitute the intrinsic rating of the institution.
36. Other than capitalization and liquidity, Moody's assesses the operating environment and quality of management as an important component of the analysis. The analysis of these two factors can be captured in the form of adjustment of the intrinsic financial strength score. Finally, Moody's assesses membership support in order to potentially upgrade the adjusted rating by three notches.

C. Fitch

37. Fitch defines three different supranational entities covered by its methodology (May 2018): MDBs, which are public entities controlled by member states and not subject to jurisdiction; supranational financial guarantors, whose main activity is to provide guarantees and other forms of credit enhancements; and supranational administrative bodies, which are involved in financing activities but have no capital.
38. In general, Fitch's approach to the assessment of DFIs is based on a dual scoring system. The first main element of the review is the intrinsic rating, which is derived from two broad factors:
- (i) Liquidity, i.e. the size and quality of the institution's liquid assets relative to its present and future cash needs as well as the possibility of accessing market and other types of funding; and
 - (ii) Solvency, which is based on two subfactors: capitalization and risks, each assessed on a four-grade scale.
39. The second step for Fitch is to evaluate the business environment of the DFI, which depends on two factors: business profile and operating environment. Finally, Fitch evaluates the commitment of member states to provide, in case of need, extraordinary support which could determine an uplift of the final rating. This support mostly comes in the form of callable capital for most MDBs, although Fitch also accepts other types of support (such as guarantees) for institutions such as IFAD with no callable capital.

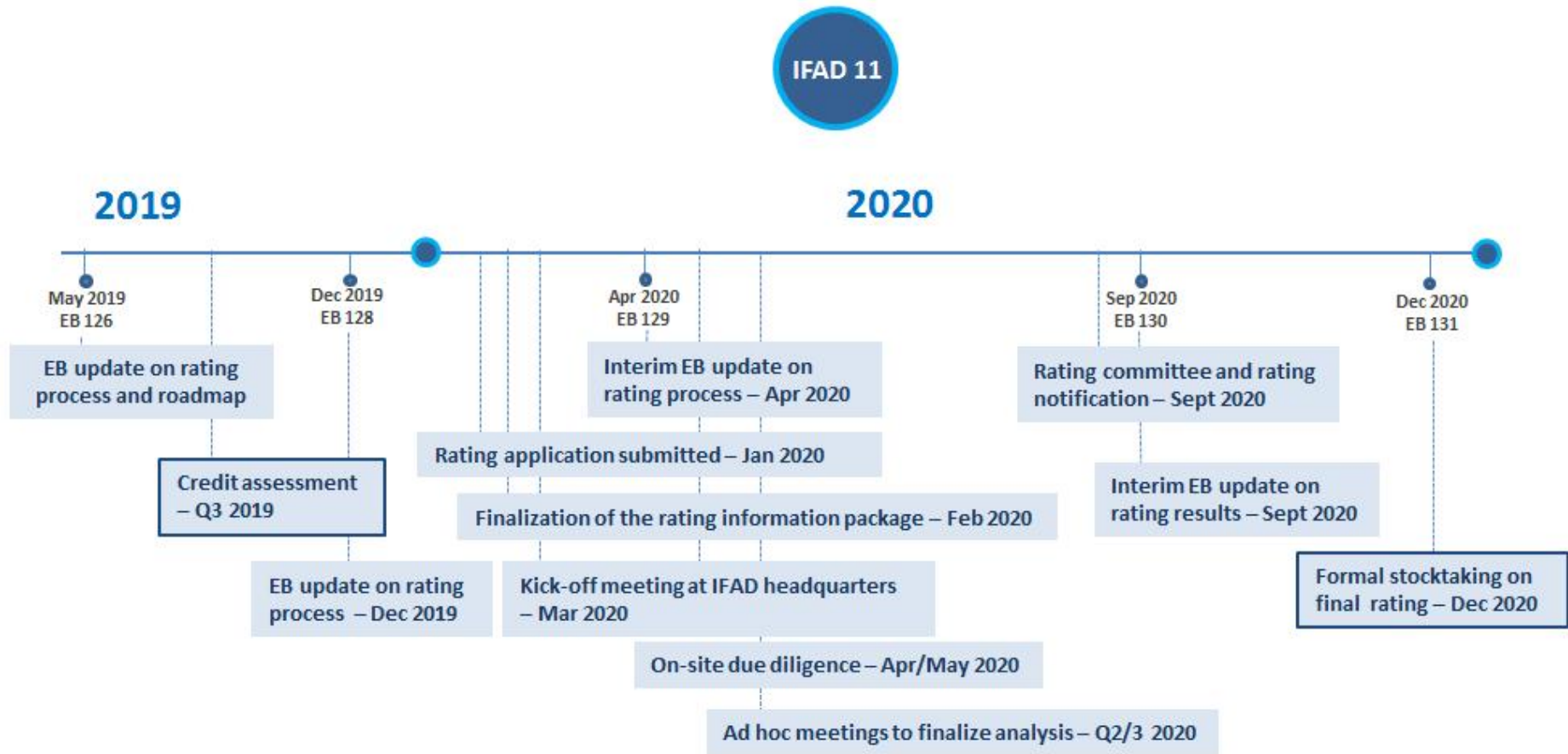
⁹ On January 2019, Moody's announced that it is seeking feedback from market participants on proposed changes to its approach to rating MDBs and OSEs. It is still uncertain when the new methodology will be formally released.

IV. Rating costs

40. An accurate assessment of the cost of obtaining a CA or a public rating can be obtained by requesting a detailed quote from one or more of the rating agencies. Management has not yet proceeded to this step as discussions with the governing bodies on this topic are pending.
41. However, while an estimate for a public rating can be made using publicly available information,¹⁰ a CA requires a tailored assessment of the exercise by the CRAs. The cost of a CA will be substantially lower than the cost of a full public rating.
42. The indicative cost of a CA depends on the scope of work that IFAD requests from the CRA. A preliminary estimate, based on the experiences of other IFIs, indicates a cost in the range of US\$100,000 to US\$200,000. Management has contacted S&P to obtain a more accurate fee quote for a CA. Executive Board representatives will be provided with a more precise estimate in due course.

¹⁰ For example, in the case of S&P, the approximate cost of obtaining a single new-issuer rating is US\$250,000. Usually this includes the cost of rating an inaugural first bond issuance. It is important to note that the costs associated with obtaining a public rating for a first-time (sovereign or DFI) issuer are based on the following variables: number of ratings sought; one-off bond issue or bond programme; frequency of future bond issuance; and complexity of the financial and legal structures.

Indicative timeline for IFAD to obtain a rating



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