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Investing in rural people

Debt Sustainability Framework for IFAD11

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Abbreviations and acronyms

DSF	Debt Sustainability Framework
IFAD11	Eleventh Replenishment of IFAD's Resources
IFIs	international financial institutions
IMF	International Monetary Fund
PBAS	performance-based allocation system

Recommendation for approval and transmittal to the Executive Board

The Audit Committee is invited to endorse the recommendation presented in paragraph 11 below.

Debt Sustainability Framework for IFAD11

I. Context

1. The volume and expected composition of IFAD's triannual programme of loans and grants (PoLG) is determined through replenishment consultations, based on the Fund's expected resource flows as contained in its financial framework, including Member States' agreed contributions and the expected concessionality of IFAD's financial instruments for borrowing Member States.

2. For the Eleventh Replenishment of IFAD's resources (IFAD11), the PoLG was set at US$3.5 billion, including grant financing of US$586 million (16.7 per cent of the PoLG) through the Debt Sustainability Framework (DSF), as per the forecast financial framework for the replenishment cycle.[1]

3. The revision of IFAD's performance-based allocation system (PBAS) formula as agreed in 2017 and the IFAD11 commitments channelled a greater volume of IFAD's resources to poorer countries. With the deteriorating debt sustainability of these countries and a more restricted number of borrowing countries (80), the resulting PoLG composition created a mismatch between the lending terms (percentages and volumes) approved in the IFAD11 financial framework and the PBAS outputs, resulting in grant financing of US$860 million (24.6 per cent of the PoLG).

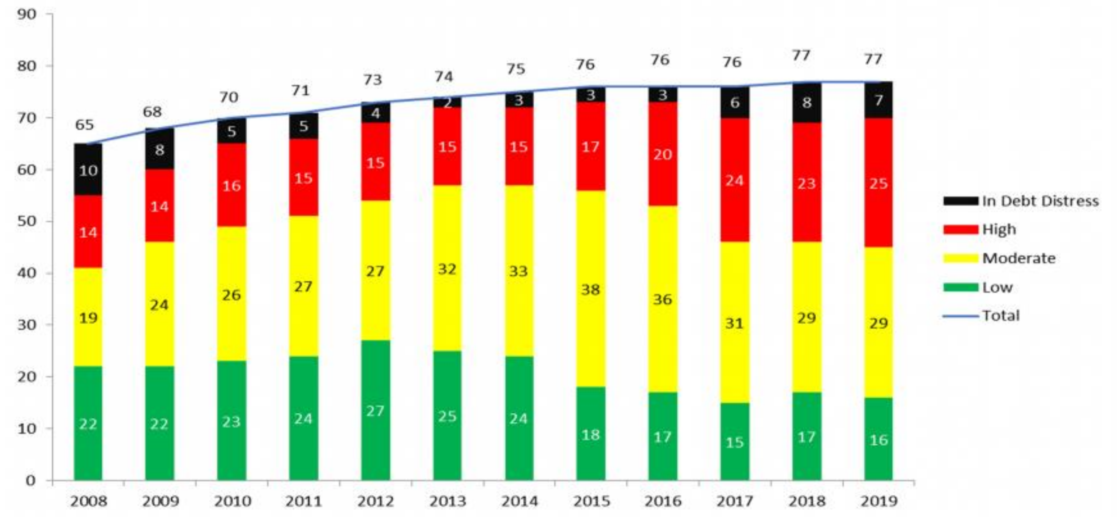
4. This would mean an additional burden of US$274 million in DSF compensation, decreasing IFAD's financial sustainability and increasing the overall compensation due from donors for DSF commitments approved between 2007 and 2021 to US$2.8 billion instead of the US$2.5 billion forecast. It should be noted that two recent reviews of the Fund's financial architecture by the Independent Office of Evaluation IFAD and Alvarez & Marsal both identified the DSF as one of the highest sources of risk for IFAD due to its significant negative impact on the Fund's financial sustainability.

5. In light of this, IFAD Management has proposed that the Executive Board revise the percentage eligibility of countries for the DSF in IFAD11. It is under the direct delegation of authority of the Executive Board to so do.

6. Graph 1 below reflects that the number of IFAD borrowers in moderate or high risk of debt distress, or in debt distress that has increased significantly since 2007, when the DSF was approved. Analyses by the International Monetary Fund (IMF) of the reasons for the deterioration of specific countries reveal that in some countries, the debt burden is intrinsic to historic economic situations, while in others it is caused by long-term government strategies of borrowing on less concessional terms, which could lead to default should expectations not be met. This also increases the risk of moral hazard.

[1] Section IV of Report of the Consultation on the Eleventh Replenishment of IFAD's Resources (GC41/L.3/Rev.1).

Graph 1
Evolution of IFAD's borrowers eligible for the DSF as per risk of debt distress, 2008-2019



7. The level of debt distress among IFAD's borrowers has shown a steady increase since IFAD adopted the DSF initiative in 2007: the number of borrowers in debt distress or at high risk of debt distress rose from 23 in 2016 to 32 in 2019. This is a major factor driving the volume of DSF resource allocations. For the IFAD11 PoLG, the change in risk of debt distress from the original the PBAS negotiations during replenishment consultations to the establishment of the final lending terms resulted in an additional US$145 million in DSF allocations.

II. Background

8. In 2007, the Governing Council adopted the DSF (GC 29/L.4), which allowed the Fund to provide much-needed debt relief to the poorest countries. As of 31 December 2018, IFAD had provided the equivalent of US$1.9 billion in DSF financing.

9. Through the DSF, eligible Member States that are assessed to be at moderate risk of debt distress have historically received 50 per cent of their allocation on grant terms and 50 per cent on highly concessional loan terms, and those assessed to be at high risk of or in debt distress have received 100 per cent of their allocations on grant terms.[2]

10. A long-term solution to the DSF mechanism is currently being explored with the Executive Board and will be tackled separately. However, a short-term response is required for the Fund to continue its operations in DSF-eligible countries during IFAD11. At the 125th session of the Executive Board in December 2018, Management presented the rationale for maintaining the PBAS formula agreed by the Board in 2017, along with a proposal for changing the eligibility percentage for DSF countries (EB 2018/125/R.4 Add.1). The PBAS allocations were approved, but the Executive Board decided that additional time was required to consider the matter, and that a decision would be taken no later than May 2019. Financing for the 32 DSF-eligible countries under IFAD11 has therefore been postponed subject to the Executive Board decision.

[2] As per EB 2007/90/R.2.

III. Proposal for IFAD11

11. In this context, Management has proposed to reduce the percentage of DSF grant resources offered to eligible countries as follows:

(i) Countries eligible to receive 100 per cent of their allocation on DSF grant terms would be offered 80 per cent of their allocation on DSF grant terms and the remaining 20 per cent on highly concessional terms, which would be optional; and

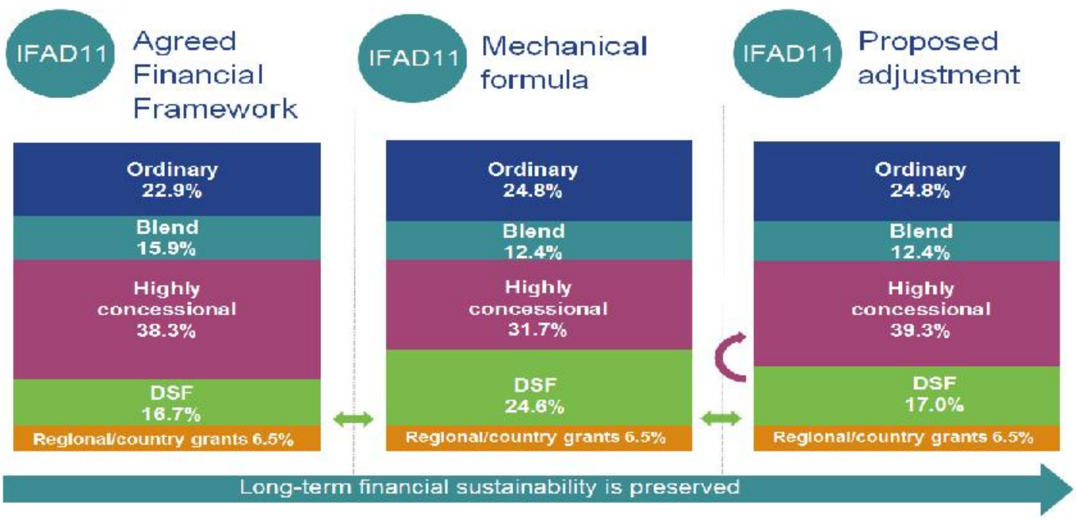
(ii) Countries eligible to receive 50 per cent of their allocation on DSF grant terms would be offered 27 per cent of their allocation on DSF grant terms and the remaining 73 per cent on highly concessional terms, with 46 per cent of the original allocation offered on highly concessional terms, which would be optional.

12. Table 1 below provides a comparison between IFAD's current offer and two different scenarios for an allocation of US$10 million, for two categories of debt distress, including the related grant element (see also annex 1).

Table 1
Example showing proposed changes for an allocation of US$10 million and related grant element

	Current status				**Proposed changes with additional highly concessional portion taken up by country**				**Proposed changes with additional highly concessional portion not taken up by country**			
	Highly concessional portion	**Grant portion**	**Total**	**Grant element**	**Highly concessional portion**	**Grant portion**	**Total**	**Grant element**	**Highly concessional portion**	**Grant portion**	**Total**	**Grant element**
Country in or at high risk of debt distress	0	10	10	**100%**	2	8	10	**91%**	**0**	8	8	**100%**
Country at moderate risk of debt distress	5	5	10	**79%**	7.3	2.7	10	**69%**	2.7	2.7	5.4	**79%**

13. IFAD Management's proposal would result in a reduction in DSF financing to 17 per cent of the PoLG in line with the approved financial framework shown below.



14. One of the cornerstones of Management's proposal is that the additional highly concessional loans compared to the historic percentages are optional. Thus, borrowers would have the option of not drawing on the additional loan and could take up resources at exactly the same percentages as in the past if they choose to. Resources not taken up by borrowers would be reallocated as provided for in the PBAS. Priority would be given to low-income countries and lower-middle-income countries in order to preserve the commitment to provide 90 per cent of core resources to these groups of countries, also considering their absorption capacities.

15. This proposal does not represent an area of policy misalignment with the DSF practices of other international financial institutions (IFIs) since IFAD continues to base its methodology on IMF and World Bank debt sustainability analyses.

IV. Considerations of IFAD Management's Proposal for IFAD11 DSF

16. It is appreciated by IFAD Management that the Fund's mission is to eradicate rural poverty. Management recognizes that in the last replenishment, IFAD's stakeholders requested that more resources be allocated to poorer countries. Furthermore, it is recognized that IFAD should not unduly contribute to the debt burden of countries with difficulties servicing such debt.

17. The three pillars of IFAD's financing framework – donor contributions, PoLG volumes and concessionality – are intimately entwined, and a change in one of them has an impact on the others, as shown below.

18. There must be a connection between Members' willingness to fund DSF countries on grant terms and their explicit funding based on those decisions. For IFAD11, there is a mismatch between the lending term percentages and volumes (as already mentioned) approved in the IFAD11 financial framework, and the outputs of the PBAS negotiations.

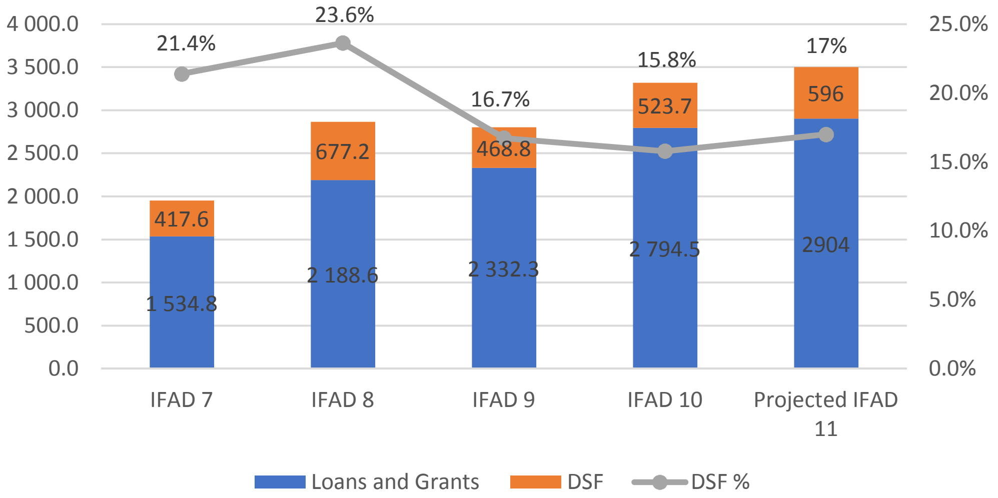
19. In order to assess the potential impact of this proposal on DSF-eligible countries, particularly those in or at high risk of debt distress, Management carried out several analyses of: trends in debt distress during the last decade; the total volume of resources made available; the level of concessionality of IFAD's overall package; debt absorption capacities; and proposed options available to borrowers. IFAD's approach to DSF implementation was also compared to those of other IFIs.

A. Impact on overall allocated volume of DSF resources

20. In terms of volume of resources, based on a 9 per cent increase in the Fund's PoLG from US$3.2 billion in IFAD10 to US$3.5 billion in IFAD11, total allocations to all DSF countries increased sharply from US$742 million to US$1.22 billion (an increase of US$476 million or 64 per cent). Actual DSF grant funding increased from US$523.7 million to US$596 million during the same period. Management's

proposal would mean an increase in DSF financing in both absolute and percentage terms from IFAD10 (see graph 2 below).

Graph 2
Evolution of DSF volume from IFAD7 through IFAD11



B. Impact on allocated volume of DSF resources and grant element related to countries in or at high risk of debt distress

21. The resources allocated for the 16 countries in or at high risk of debt distress, and which had original PBAS allocations in both IFAD10 and IFAD11, increased from US$313 million in IFAD10 to US$503 million in IFAD11 – an increase of US$190 million or 61 per cent.

22. Even if borrowers choose to take up only 80 per cent of their DSF grant allocations, Management's proposal would still result in higher grant allocations in IFAD11 than in IFAD10 for all borrowers in or at high risk of debt distress, considering the fact that Yemen did not take up the original IFAD10 allocation.

23. Furthermore, it would mean an overall increase in DSF grants both in absolute and percentage terms from IFAD10. With the total grant allocation increasing from US$281 million to US$388 million, the overall DSF volume would increase by an average of 38 per cent.

24. Table 2 below shows the detailed allocation by country for the different scenarios. In terms of volume, even without the optional additional highly concessional resources, countries in or at high risk of debt distress would benefit from higher allocation volume than in IFAD10, except for Yemen, Kiribati and Samoa (the original IFAD10 allocation was not used by Yemen and no allocation was provided to Kiribati and Samoa).

Table 2
Comparison of DSF volumes in IFAD10 and IFAD11 for countries in or at high risk of debt distress

Country	IFAD11 final allocation	DSF Current proposal (80%)	Original IFAD10 allocation
Afghanistan	50 000 000	40 000 000	25 000 000
Burundi	63 654 876	50 923 901	50 922 368
Central African Republic	35 329 100	28 263 280	10 513 114
Chad	61 683 313	49 346 650	32 563 308
Eritrea	37 079 751	29 663 801	19 074 351
Gambia, The	21 270 237	17 016 190	16 254 290
Haiti	23 810 139	19 048 111	12 080 408
Mauritania	23 696 976	18 957 581	16 248 089
Mozambique	85 363 718	68 290 974	50 095 929
Sao Tome and Principe	5 330 051	4 264 041	3 325 499
South Sudan	9 866 989	7 893 591	7 034 553
Sudan	62 944 628	50 355 702	34 558 879
Tonga	4 500 000	3 600 000	3 000 000
Total	484 529 778	387 623 823	280 670 788
Kiribati	4 500 000	3 600 000	-
Samoa	4 500 000	3 600 000	-
Yemen	10 000 000	8 000 000	32 113 980
Total	503 529 778	402 823 823	312 784 768

25. As detailed in annex I, the proposal would not severely affect the concessionality of the overall financial package offered by IFAD, which is 91 per cent for countries in or at high risk of debt distress compared to 100 per cent historically.

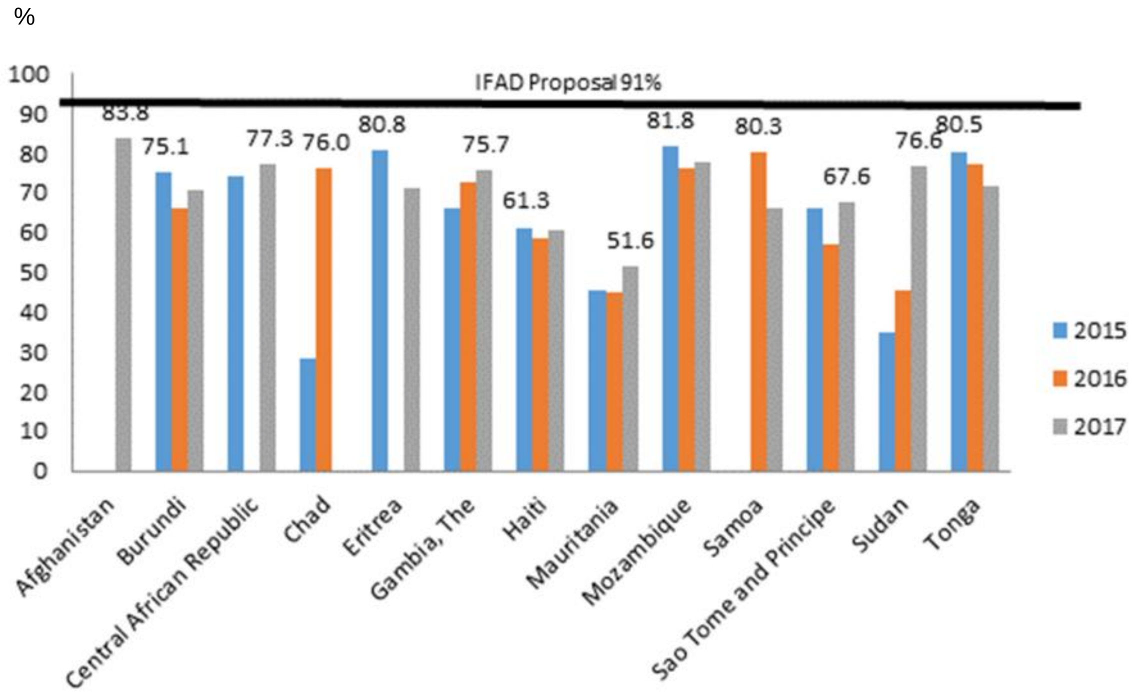
26. In all cases, IFAD financing would not be below the minimum concessionality required by the IMF for countries with fiscal or economic constraints in place. The minimum concessionality required by the IMF for such countries ranges from 35 per cent to 60 per cent for higher-risk countries. In all cases, the interest burden would be extremely low, as illustrated in box 1.

Box 1. Interest burden for countries in or at high risk of debt distress

In the case of a country with an IFAD11 allocation of US$50 million (equivalent to approximately EUR 44 million), the highly concessional loan portion would amount to EUR 8.8 million. The average semi-annual service charge on the outstanding principal payable over the repayment period would be slightly less than EUR 13,450.

27. The International Debt Statistics[3] show the average grant element (in percentage terms) of new public and publicly guaranteed commitments to official creditors (multilateral and bilateral) from 2015 to 2017 for countries classified as in or at high risk of debt distress. IFAD is classified in this category of creditors. For all countries in debt distress or at high risk of debt distress, the proposed level of concessionality is higher than the average concessionality between 2015 and 2017, and appreciably so in many cases. The fact that countries would be offered part of the DSF resources on highly concessional terms would not significantly impact the overall weight of the grant element in their aggregate debt situations. This demonstrates that IFAD would not create significant additional debt burden to concerned countries. In addition, countries would be able to choose whether or not to take up these additional resources.

Graph 3
IFAD11 countries in or at high risk of debt distress: Average grant element



C. Impact on allocated volume of DSF resources and grant element for countries at moderate risk of debt distress

28. The overall resources allocated to the 16 countries at moderate risk of debt distress, and which had original PBAS allocations in both IFAD10 and IFAD11, increased from US$499 million in IFAD10 to US$715 million in IFAD11 – an increase of US$216 million or 43 per cent.

29. For the 16 countries with moderate risk of debt distress, the proposed change would result in a higher grant volume in IFAD11 compared to IFAD10 for six countries, while 10 countries would see a decreased volume of grants (see table 3). Overall, the volume of grant resources for countries at moderate risk

[3] The International Debt Statistics, published annually by the World Bank, present the results of analyses on external debt and financial flows (debt and equity) for the world's economies. The 2019 edition, published in November 2018, provided time-series data for over 200 indicators from 1970 to 2017. One of these indicators is the average grant element of new commitments contracted by borrowers (https://data.worldbank.org/products/ids).

of debt distress would decrease by US$56 million (23 per cent) from US$249 million to US$192 million.

30. As seen in annex I, the proposal would not severely affect the concessionality of the overall financial package offered by IFAD, which is 69 per cent for countries in or at moderate risk of debt distress, compared to 79 per cent historically.

31. In all cases, IFAD financing would not be below the minimum concessionality required by the IMF for those countries with fiscal or economic constraints in place. The minimum concessionality required by the IMF for such countries ranges from 35 per cent to 60 per cent for higher-risk countries. In all cases, the interest burden would extremely low, as illustrated in box 2.

Box 2. Interest burden for countries at moderate risk of debt distress

In the case of a country with an IFAD11 allocation of US$50 million (equivalent to approximately EUR 44 million), the highly concessional loan portion would amount to EUR 32.12 million. The average semi-annual service charge on the outstanding principal amount payable over the repayment period would be slightly more than EUR 47,100.

Table 3
Comparison of DSF volumes in IFAD10 and IFAD11 for countries at moderate risk of debt distress

Country	IFAD11 allocation					IFAD10 original allocation		
	Highly concessional 27%	DSF 27%	Subtotal	Optional highly concessional	Total allocation	Highly concessional 50%	DSF 50%	Total
Benin	7 901 243	7 901 243	15 802 486	13 461 377	29 263 862	15 672 481	15 672 481	31 344 962
Comoros	2 532 607	2 532 607	5 065 215	4 314 813	9 380 027	1 500 000	1 500 000	3 000 000
Democratic Republic of the Congo	9 852 510	9 852 510	19 705 020	16 785 758	36 490 778	7 500 000	7 500 000	15 000 000
Ethiopia	35 097 317	35 097 317	70 194 635	59 795 430	129 990 064	51 759 720	51 759 720	103 519 439
Guinea	7 951 993	7 951 993	15 903 986	13 547 840	29 451 826	15 259 749	15 259 749	30 519 498
Guinea-Bissau	5 181 139	5 181 139	10 362 279	8 827 126	19 189 405	3 366 823	3 366 823	6 733 647
Kyrgyzstan	8 519 700	8 519 700	17 039 399	14 515 044	31 554 443	12 714 167	12 714 167	25 428 335
Liberia	9 191 311	9 191 311	18 382 622	15 659 271	34 041 892	11 983 068	11 983 068	23 966 136
Madagascar	22 545 624	22 545 624	45 091 247	38 411 062	83 502 309	31 856 465	31 856 465	63 712 931
Malawi	22 621 646	22 621 646	45 243 292	38 540 582	83 783 874	21 175 388	21 175 388	42 350 777
Maldives	1 215 000	1 215 000	2 430 000	2 070 000	4 500 000	-	-	-
Mali	14 486 933	14 486 933	28 973 867	24 681 442	53 655 308	15 570 794	15 570 794	31 141 588
Niger	23 864 625	23 864 625	47 729 250	40 658 250	88 387 501	29 920 134	29 920 134	59 840 268
Sierra Leone	11 022 943	11 022 943	22 045 886	18 779 829	40 825 715	10 721 399	10 721 399	21 442 798
Tajikistan	6 750 000	6 750 000	13 500 000	11 500 000	25 000 000	12 290 490	12 290 490	24 580 981
Togo	4 198 717	4 198 717	8 397 435	7 153 370	15 550 805	8 144 583	8 144 583	16 289 166
Total	192 933 309	192 933 309	385 866 618	328 701 193	714 567 811	249 435 263	249 435 263	498 870 526

D. Difference between IFAD and other IFIs in addressing the DSF

32. A review of DSF practices among the five other IFIs that have adopted the DSF framework revealed that they are broadly harmonized with IFAD in terms of the percentage eligibility afforded to individual DSF countries, with only a few variations. Various institutions are considering significant reforms in this area. A review of projects in countries at moderate risk of debt distress by the International Development Association (IDA) revealed that not all financing was approved on a strict basis of 50 per cent grants and 50 per cent highly concessional loans. In general, projects with higher expected returns were primarily financed by loans while "softer" activities were financed by grants. Thus, borrowers had the fiscal space to absorb modest levels of debt.

33. Moreover, there are important differences between IFAD's role as a development finance institution and those of other IFIs due to their differing legal structures: IFAD does not have a predetermined, legally binding burden-sharing mechanism for Member States. Unlike IFAD, other IFIs such as the Asian Development Bank (AsDB) and the African Development Bank (AfDB) have a separate DSF replenishment contribution that comprises an explicit mechanism to fund this portion of the PoLG, in addition to core replenishment contributions.

34. Another striking difference regards the practice applied to volume allocations for DSF grant resources in other IFIs. Compared to IFAD's 5 per cent, AfDB and AsDB apply a 20 per cent volume reduction to the allocation of grant-eligible countries, of which approximately 15 per cent is used to cover the foregone service charges (in IFAD, none is applied). The IDA also applied the 20 per cent volume reduction until IDA18, when this practice was discontinued since the institution was able to recover the foregone income through other channels.

35. Management would like to emphasize that the proposed approach will only apply to IFAD11 (in the same way the current PBAS methodology applies only to IFAD11), and will ensure that the DSF principles established by the World Bank and IMF continue to be adopted at IFAD.

V. Conclusion

36. IFAD Management recognizes the juxtaposition of issues that appear irreconcilable: the requirement to provide additional debt relief to countries through the DSF in order to avoid increasing their cumulative national debt burdens, and the need to preserve IFAD's financial sustainability.

37. In the light of the fact that:

- The proposal aligns with the financial framework underpinning IFAD11 while maintaining high resource allocations to poorer countries;
- Members' funding for IFAD11 does not cover the higher proportion of DSF resource needs;
- There must be a strong link between the willingness to fund DSF countries in grant terms and the related funding and concessionality;
- The additional debt burden is optional for borrowers, which may choose not to take up the entire PBAS allocations with the additional highly concessional terms;
- IFAD continues to be harmonized with the underlying DSF frameworks of the IMF and World Bank in terms of baselines and percentage eligibility according to debt distress status;

- Even without the additional highly concessional loans, countries in or at high risk of debt distress would have higher allocations of DSF grant resources than in the original IFAD10 PBAS allocation (the total volume of allocations for the 32 countries eligible for DSF financing in IFAD11 increased from US$742 million to US$1.22 billion); and
- The proposed short-term solution for IFAD11 would not have significant negative impacts on countries' debt burden since the overall financing package would be within the limits allowed by the IMF and remain highly concessional,

Management proposes a one-off application DSF eligibility on an optional basis to borrowers in line with the percentages shown in paragraph 11 in order to allow for continuation of IFAD's operations without further delay.

Concessionality level comparison

The concessionality rates shown below are indicative and were calculated using the World Bank’s FY19 Q2 rates (available at http://treasury.worldbank.org/en/about/unit/treasury/ida-financial-products/lending-rates-and-fees). These rates are based on loans denominated in special drawing rights and euros; United States dollar-denominated loan data indicates slightly less concessionality.