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Investing in rural people

## IFAD's Integrated Borrowing Framework

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## **Abbreviations and acronyms**

AFD	Agence Française de Développement
ALM	asset and liability management
CPL	concessional partner loan
DFI	development finance institution
ESG	environmental, social and governance
IBF	Integrated Borrowing Framework
IDA	International Development Association
KfW	KfW Development Bank
IFAD12	Twelfth Replenishment of IFAD's Resources
MDB	multilateral development bank
PoLG	programme of loans and grants
SBF	Sovereign Borrowing Framework

## Executive summary

- 1. Borrowing will continue to play an important role for IFAD in realizing its ambitions.** In line with the Addis Ababa Action Agenda, and as highlighted in the strategic directions for the Twelfth Replenishment of IFAD's Resources (IFAD12),<sup>1</sup> IFAD's ambition is to increase financing to all eligible borrowers while preserving its own financial sustainability. This step-up is needed to maximize its support of the 2030 Agenda for Sustainable Development and is now becoming even more vital, in light of the global challenges that are affecting IFAD's Member States as a result of the COVID-19 emergency. While replenishment will remain the bedrock of IFAD's financing, IFAD is conscious that the macro outlook for both contributing and receiving Member States is such that financing needs may rise in direct correlation with a scarcity of easily accessible funding. To reach the levels of delivery required to make a significant impact for IFAD's beneficiaries, borrowing is a necessary component of funding for IFAD. IFAD's universal client base represents a key operational and financial strength, since borrowed resources could be used not only to finance projects in upper-middle-income countries, but also to finance selected lower-middle-income countries and low-income countries borrowing on semi-concessional and concessional terms.<sup>2</sup>
- 2. The Integrated Borrowing Framework (IBF) is a crucial tool to increase IFAD's access to funding in an efficient and cost-effective manner.** The existing Sovereign Borrowing Framework (SBF) and Concessional Partner Loan (CPL) Framework have been key to increasing IFAD's ability to deliver from IFAD10 onwards. Their scope is, however, limited to sovereign counterparts and to bilateral loans. The bilateral nature of a sovereign loan could limit existing lenders from further financing IFAD due to concentration risk, and it also gives the lender more control to dictate terms. The IBF proposes some innovations and two updates from the previous SBF to strengthen IFAD's borrowing capacity by diversifying its funding sources and improving the timeliness and pricing of borrowing.
- 3. The IBF is also an important tool to strengthen IFAD's liquidity management.** The primary goal of IFAD's liquidity is to honour disbursement obligations for approved loans and grants to Member States. In line with IFAD's Liquidity Policy,<sup>3</sup> IFAD will enhance its focus on planning its short-term liquidity. Through the IBF, IFAD will be in a better position to strengthen its liquidity as and when needed to disburse its growing programme of loans and grants in a timely manner.
- 4. Nevertheless, IFAD's leverage will grow gradually, and will remain below the 35 per cent debt/equity ceiling during IFAD12.** Management is conscious of the need to follow a prudent path in increasing leverage. The IBF therefore does not propose an increase in any of the existing financial ratios,<sup>4</sup> as established in 2015 by the SBF and applied also to exposure through CPLs. This level of leverage remains appropriate for the ambitions of IFAD12.
- 5. The IBF supersedes and replaces the SBF and the CPL Framework and integrates certain provisions of these previous frameworks into a holistic framework.** The IBF establishes and regulates five pillars governing all of IFAD's borrowing activities. These pillars are: eligible lenders, types of borrowing instruments, use of borrowed funds, borrowing governance, and borrowing limits and risk management. The IBF is a self-contained comprehensive document that integrates relevant provisions from the SBF and the CPL Framework; IFAD may continue to enter into sovereign and CPL borrowing arrangements, subject to the

<sup>1</sup> See IFAD12: Strategic Directions (IFAD12/1/R.6).

<sup>2</sup> The latter through concessional loans such as CPLs.

<sup>3</sup> See the 2006 Liquidity Policy (EB 2006/89/R.40) and the Approach to IFAD's New Liquidity Policy: Principles and Guidelines (EB 2019/128/R.47). For clarity, references in the IBF to the Liquidity Policy will be, as applicable, to the 2006 Liquidity Policy or the Approach to IFAD's New Liquidity Policy: Principles and Guidelines.

<sup>4</sup> See section III.E.

criteria of this IBF. Relevant provisions of the CPL Framework are imported into this IBF and set out in section IV and annex I hereto. For the avoidance of doubt, loans signed prior to the approval of this IBF will be governed by the CPL Framework and/or the SBF in effect at the time of their approval, as applicable.

6. Within its five pillars, the IBF proposes two innovations – pillars A and B – and two updates from the original SBF – pillars A and E. No changes from the original SBF are proposed in pillar C, which relates to the use of borrowed funds, nor in pillar D, which regulates the governance over borrowing.

**Innovations:**

- A. **Eligible lenders.** In addition to sovereign states and state-supported institutions,<sup>5</sup> the IBF proposes to include supranational and multilateral institutions as well as private institutional investors with a focus on impact investing (e.g. sustainable, social and green finance) in the pool of eligible lenders.
- B. **Types of borrowing instruments.** The IBF proposes to introduce the possibility of borrowing through private – bilaterally negotiated – bonds, in addition to bilaterally negotiated loans.

**No changes:**

- C. **Use of borrowed funds.** The IBF does not propose changes in the use of borrowed funds. Borrowing will be used to finance IFAD's loan assets at IFAD's prevailing pricing conditions, ensuring no earmarking and no subsidization from IFAD's own resources.
- D. **Borrowing governance.** The IBF does not propose changes in the authority required to enter into borrowing agreements: all lenders and borrowing agreements (including with existing lenders) will be submitted to the Executive Board for approval. To ensure timely and cost-efficient access to borrowing, Management may, if appropriate, request the Executive Board's approval of lenders and borrowing proposals by correspondence on a no-objection basis (or any other means as may be agreed from time to time). A yearly funding plan will also be approved by the Executive Board, and will be presented to the Executive Board at the same time as the approval of the resources available for commitment document.

**Update from the original SBF:**

- E. **Eligible lenders.** The IBF proposes to disapply the additionality provision in the existing SBF which foresaw that IFAD could only enter into a borrowing transaction with a Member State or state-supported institution if the Member State's core replenishment was at least 100 per cent of the amount contributed in the previous replenishment cycle. Considering IFAD's increasing reliance on borrowing, this provision limits borrowing opportunities from state-supported institutions and does not add value to IFAD's borrowing. The additionality rule will remain valid for CPLs, as further detailed in section IV.
- F. **Borrowing limits and risk management.** The IBF proposes to use a more prudent and conservative computation of the debt/equity ratio, aligning IFAD with industry best practice and methodologies followed by credit rating agencies.
7. **The new Asset and Liability Management (ALM) Framework<sup>6</sup> will be fully operationalized** with enhanced measurement, monitoring and reporting to manage borrowing within IFAD's risk appetite. As IFAD accesses funding from a

<sup>5</sup> Sovereign states refer to IFAD Member States and sovereign states that are not Members of IFAD. State-supported institutions include all state-owned or state-controlled enterprises and development finance institutions of IFAD Member States.

<sup>6</sup> See document EB 2019/128/R.46.

broader pool of lenders with a diversified range of financial instruments and terms, the newly introduced ALM Framework will be key in driving IFAD's borrowing strategy. The ALM Framework will be supported by an upgrade of IFAD's financial model. This will allow for enhanced monitoring of IFAD's debt maturity and repricing profiles and more accurate calculation of the duration of assets and liabilities to ensure that mismatches are managed across the entire balance sheet to protect IFAD's capital.

8. **The pillars of the IBF will apply irrespective of a decision on an allocation mechanism for borrowed funds.** Strategic decisions about a separate allocation mechanism to channel borrowing are not considered to be earmarking. Financial sustainability and avoidance of cross-subsidization of borrowed funds with Members' contributions will remain key conditions for IFAD to borrow.
9. **The IBF does not introduce the possibility of market borrowing.**<sup>7</sup> IFAD does not have the power to issue bonds in public financial markets. The authority will rest with IFAD's competent governing bodies to approve any future recommendation by Management introducing the possibility of market borrowing.

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<sup>7</sup> See resolution 204/XLI on the Eleventh Replenishment of IFAD's Resources. Public offers of bonds can give access to a wide range of retail or institutional investors. These bonds are sold through a negotiated or competitive sale and are actively traded in the secondary market.

## I. Background and rationale for the Integrated Borrowing Framework

- 1. With global demand for sovereign aid budgets expected to increase in coming years, all development finance institution (DFIs) have started to broaden their funding sources** to meet growing financing needs by optimizing the use of their balance sheets. IFAD has followed the path of other DFIs by starting to prudently leverage its equity. To increase funding for IFAD's programme of loans and grants (PoLG), in 2015, the Executive Board approved the Sovereign Borrowing Framework, which governs IFAD's borrowing from sovereign states and state-supported institutions. In 2017, the Executive Board also approved the Concessional Partner Loan Framework. Closely aligned with the frameworks introduced by the International Development Association (IDA) and the African Development Fund, the CPL Framework covers loans provided to IFAD by Member States and state-supported institutions on highly concessional terms. These terms allow onlending to IFAD Members most in need.
- 2. The current global challenges call for an even more rapid response from DFIs.** The long-term consequences of the crisis triggered by COVID-19 are still unknown. Undoubtedly, the world will face an economic downturn, while at the same time the financing needs in many countries will be exacerbated. The combined effects of these forces will require DFIs to step up their efforts to remain relevant and continue making a difference with their countercyclical financing.
- 3. IFAD is planning to continue borrowing, gradually and prudently and in line with its level of capital.** IFAD's ambition is to maximize financing for its target beneficiaries and to do so in a sustainable manner. IFAD's leverage will ultimately be constrained by the capacity of its capital to support the increase of development-related loan assets, and the path of increased borrowing will be aligned with Members' strategic guidance. During the period covered by IFAD12, the debt/equity ratio is forecast to remain below the maximum ceiling of 35 per cent established in the SBF.
- 4. To meet its goals, IFAD must broaden its lender base and remove, to the extent possible, barriers for potential counterparts.** The IFAD12: Strategic Directions paper<sup>8</sup> and the IFAD12: Business Model and Financial Framework 2022-2024<sup>9</sup> foresee various replenishment scenarios in which borrowing will be an important part of resource mobilization. While replenishment contributions will remain the bedrock of IFAD's financing, debt will play a larger role in IFAD's funding structure. Unlocking new financing opportunities is of critical importance to increase IFAD's development impact. In addition, access to liquidity in a timely manner to meet disbursement obligations should be facilitated. Through the IBF, IFAD will be in a better position to strengthen its liquidity as and when needed.
- 5. IFAD's borrowing liabilities will be managed holistically.** Irrespective of the lender, borrowing represents a financial liability on IFAD's balance sheet and finances IFAD's loan assets. As in any financial institution, the level of overall leverage should be driven by Members' risk appetite. The composition of borrowing among maturity profiles, currencies and interest rates will be linked to balance sheet exposures and monitored through the Asset and Liability Management Framework. In December 2019, Management presented its approach to the ALM Framework<sup>10</sup> and technical teams are currently working on updating its systems to provide Management and the Executive Board with more detailed reporting and clear limits.

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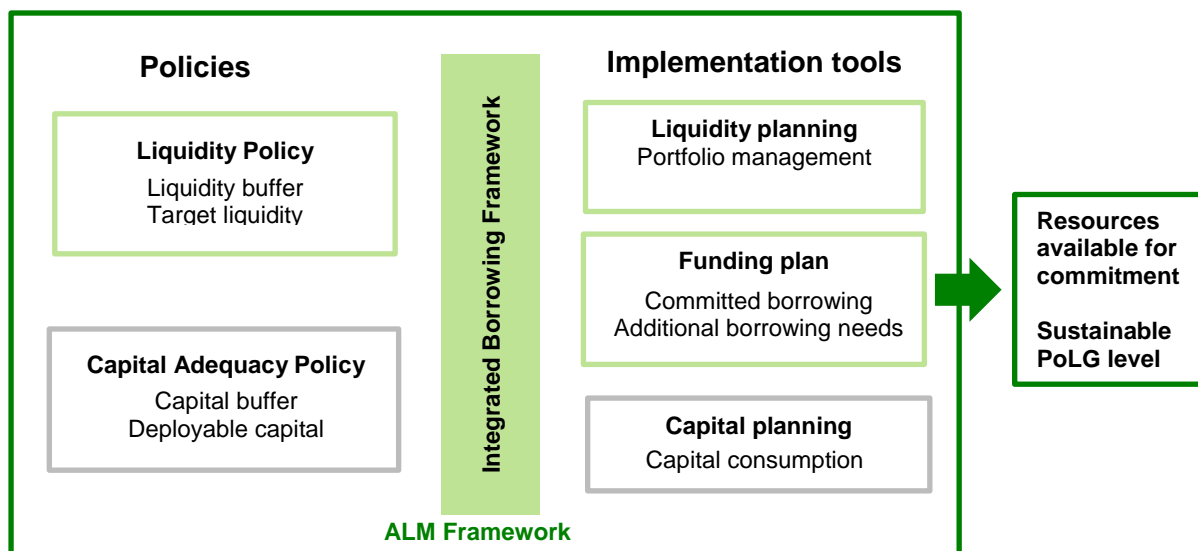
<sup>8</sup> See document IFAD12/1/R.6.

<sup>9</sup> See document IFAD12/2(R)/R.2

<sup>10</sup> See document EB 2019/128/R.46.

6. **The IBF is a financial tool and it will be applied in compliance with IFAD’s financial policies.** IFAD’s Liquidity Policy and Capital Adequacy Policy define the main boundaries for determining IFAD’s commitment (or financing) capacity. This capacity determines the sustainable level of the PoLG in accordance with the resources available for commitment (RAC), which are approved by the Executive Board. All financial policies operate within the ALM Framework, which sets the guiding principles for managing IFAD’s balance sheet exposure in order to mitigate financial risks. The funding plan, which will be approved by the Executive Board as part of the RAC, will operationalize IFAD’s borrowing and be developed in accordance with the parameters set out in the relevant financial policies.

Figure 1  
IBF relationship with existing policies and tools



7. **Limitation of liability.**<sup>11</sup> In line with the Agreement Establishing IFAD, article 3, section 3, on limitation of liability, Management will reinforce the protection of Members from liability for IFAD’s borrowing by ensuring that the funding documentation will include provisions to the effect that no Member shall be liable, by reason of its Membership, for acts or obligations of IFAD.
8. The remainder of the IBF is structured as follows: section II describes the objectives and scope of the IBF; section III describes the five pillars regulated by the IBF and elaborates on the proposed innovations; section IV outlines specific provisions that will apply to loans from Member States and state-supported institutions; annex I presents the terms and conditions for CPLs; and annex II summarizes the IBF’s proposed changes.

## II. Objectives and scope

9. The IBF aims to fulfil two objectives:
- **Objective 1: Timely and cost-effective funding.** Ensuring timely access to best-priced borrowed resources in order to fund IFAD’s needs in the most efficient manner.
  - **Objective 2: Maintaining adequate liquidity levels to meet growing disbursement needs.** IFAD’s undisbursed balance of loans has grown considerably over the last decade. Adequate liquidity should be maintained at all times to ensure IFAD’s ability to disburse and play a countercyclical role.

<sup>11</sup> See document EB 2015/114/R.17/Rev.1, para. 9.



The IBF expands the range of tools enabling IFAD to access liquidity needed to disburse development loans funded through borrowing.<sup>12</sup>

10. **The IBF establishes and regulates the five main pillars of IFAD’s borrowing activities, integrating specific provisions of the SBF and the CPL Framework.** The IBF will define the main funding principles, and integrate specific provisions applicable only to Member States and state-supported institutions. The IBF establishes the following five pillars:
- A. Eligible lenders;
  - B. Types of borrowing instruments;
  - C. Use of borrowed funds;
  - D. Borrowing governance; and
  - E. Borrowing limits and risk management.
11. Table 1 shows the proposed innovations with respect to IFAD’s borrowing activities – specifically, additional new types of lenders and funding instruments – along with two proposed updates from the original SBF. The rationale for each of these proposals is discussed in the next section.

Table 1  
**Innovations and updates introduced by the IBF**

<i>Pillar</i>	<i>Change</i>	<i>Type of Change</i>
A. Eligible lenders	Introduction of supranational and multilateral institutions, as well as private institutional investors with a focus on impact investing	Innovation
	Disapplication of additionality rule for borrowing from IFAD Member States and state-supported institutions not through CPLs	Update from the original SBF provision
B. Types of borrowing instruments	Introduction of private bilaterally negotiated bonds, i.e. private placements	Innovation
C. Use of borrowed funds	No change	No change
D. Borrowing governance	No change	No change
E. Borrowing limits and risk management	Computation of debt/equity ratio	Update from the original SBF provision

12. As shown above, within pillars A and B, the IBF proposes two innovations to expand the range of eligible lenders and borrowing instruments and one update from the original SBF. Regarding the use of borrowed funds and the governance of borrowing, i.e. pillars C and D, the IBF does not propose any changes. Within pillar E, the IBF proposes one update from the previous relevant sections of the SBF.
13. **The IBF regulates IFAD’s private borrowing transactions in the form of bilateral loans or bilateral bond transactions.** The IBF does not introduce market borrowing through the issuance of bonds in public financial markets. A positive credit rating of IFAD will likely provide a recognized signal to prospective lenders and investors of IFAD’s financial health and increase its standing as a creditworthy counterpart, thereby unlocking additional bilateral financing.

<sup>12</sup> IFAD’s current undisbursed portfolio is estimated to reach approximately US\$6 billion by the end of IFAD11, compared to US\$2.7 billion at the end of IFAD7.

### III. The five pillars of IFAD's borrowing activities

#### A. Eligible lenders

14. Sovereign states (i.e. IFAD Member States and sovereign states that are not members of IFAD) and state-supported institutions (i.e. all state-owned or state-controlled enterprises and DFIs of IFAD Member States) remain eligible lenders for IFAD. From these lenders, IFAD is allowed to borrow either through sovereign loans or through CPLs depending on the type of loan agreement negotiated.
15. With regard to borrowing from Member States and state-supported institutions, the IBF will disapply the additionality rule originally included in the SBF whereby IFAD would only enter into borrowing discussions with a Member State, or a state-supported institution supported by that Member State, if the Member State's core contribution to the latest replenishment (core replenishment contribution R0) is at least 100 per cent of the amount contributed in the previous replenishment cycle (core replenishment contribution R-1).<sup>13</sup>
16. Disapplying the additionality rule recognizes that the need for borrowing is increasing, and loans that would fall under the SBF are not necessarily granted by the same counterpart as IFAD's core contributions. The substitution risk against core resources is therefore limited if not absent, and IFAD should not impose unnecessary restrictions. While CPLs grant voting rights for the embedded grant element, there is no grant element nor voting rights for Members that provide IFAD with a loan regulated by the existing SBF. The CPL Framework provides adequate safeguards against substitution risk by retaining the additionality clause.
17. There is a broad pool of other potential lenders whose interests closely align with IFAD's mandate, and IFAD should seize this opportunity to raise financing through such counterparts. The IBF therefore introduces the possibility to borrow from the following additional types of lenders:
  - (i) **Supranational and multilateral institutions.** These institutions are natural counterparts for IFAD. IFAD is already collaborating with many multilateral institutions, which provide the largest share of international cofinancing for IFAD's projects and programmes and complement each other's and IFAD's goals. The political push for increased collaboration among a specific class of multilateral institutions (MDBs), and between MDBs and United Nations agencies, is increasing. National development entities such as KfW Development Bank (KfW) and Agence Française de Développement (AFD) and highly rated MDBs borrow funds regularly through their Treasury operations through the issuance of bonds in financial markets. Similarly to KfW and AFD, these institutions might therefore be in a position to onlend borrowed funds to IFAD at attractive conditions<sup>14</sup> through bilateral loan agreements as well as by potentially buying IFAD's future private placement bonds. These types of funding activities are standard practice across MDBs and development institutions, and do not involve onlending of the relevant entities' members' contributions (or paid-in capital in the case of banks). Along these same lines, and with capital preservation being IFAD's first concern, IFAD invests its liquidity pending disbursements in highly rated bonds of other supranational and multilateral institutions, government agencies and regional development institutions in its own investment portfolio.<sup>15</sup> From a political perspective,

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<sup>13</sup> An exception to this will be where a Member State's core replenishment contribution R-1 was higher, by 10 per cent or more, than its core contribution to the immediately preceding replenishment (core replenishment contribution R-2). In such a case, the Member State's core replenishment contribution R0 should be at least 100 per cent of its core replenishment contribution R-2, in order for IFAD to determine whether or not to enter into a borrowing arrangement with the Member State concerned.

<sup>14</sup> The on-lending conditions and the viability for IFAD depend on the own funding cost of the institution.

<sup>15</sup> As at 28 June 2020, IFAD was holding about US\$468 million invested in 20 international financial institutions and development banks.

some of these institutions might have an interest in indirectly supporting IFAD's mission and priorities.

- (ii) **Private institutional impact investors, including environmental, social and governance (ESG) investors.** Entities that are not state-owned or state-supported and are focused on investing in assets that address ESG issues, including agricultural development and food systems, fall into this category, with large untapped potential for IFAD. The ESG market has experienced strong growth, as demonstrated by the growth in the number of signatories to the United Nations-supported Principles for Responsible Investment (PRI)<sup>16</sup> and the volume of their assets under management, shown in figure 2. Aligned with the growth in investor interest, the volume of green, social and sustainability bonds has experienced unprecedented growth.

Figure 2  
Growth of PRI signatories and assets under management from 2006 to 2019



Source: Crédit Agricole

18. **The priorities of such investors are aligned with IFAD's mission.** Strategic objective 3 of the IFAD Strategic Framework 2016-2025 highlights the need to strengthen the environmental sustainability and climate resilience of poor rural people's economic activities. In addition, IFAD's proven and measurable contribution to the 2030 Agenda for Sustainable Development and the link to several of the Sustainable Development Goals make it a natural partner for investors with a focus on environmental and social returns.
19. **Supranational and multilateral institutions and private institutional investors would not be entitled to voting rights.** As they do not contribute to IFAD's replenishment, such lenders would not be entitled to any voting rights, and the rule relating to additionality to counter substitution risk would not be applicable.
- B. Types of borrowing instruments**
20. **Borrowing through bilateral loans will continue.** IFAD has so far borrowed from Member States and state-supported institutions through bilateral loan agreements negotiated with each lender. IFAD may continue to enter into these types of agreements as they also strengthen partnerships with Members and their development agencies.
21. **The IBF introduces the use of bilaterally negotiated bonds by way of private placements to unlock financing from a significantly larger lender base.** Offering a different borrowing instrument will also increase funding

<sup>16</sup> A set of six principles that provide a global standard for responsible investing related to ESG factors.

opportunities. Many financial market participants, including DFIs, prefer to invest in bonds that they can add to their securities portfolios rather than entering into loan agreements. Assuming IFAD receives a positive credit rating, sovereign agencies and regional development institutions have already expressed a desire to engage in private placement bond transactions that can be negotiated on a bilateral basis.

22. **The essence of a private placement bond is very similar to that of a loan agreement, with additional flexibility.** Table 2 compares the main characteristics of a private placement with a bilateral loan. A significant advantage of a private placement is the higher flexibility in negotiating shorter maturity profiles and lower interest rates, which would enable IFAD to obtain more advantageous terms. A private placement will require different documentation (which would likely be governed by a local law, either of the lender or of a recognized reputable legal system, such as that of England or New York, with a provision for submission to arbitration). The standard financing terms can be tailored similarly to those in the loan agreements already signed by IFAD with development banks under the SBF.

Table 2

**Comparison between private placement of bonds and bilateral loan**

	<i>Private placement</i>	<i>Bilateral loan</i>
Definition	Securities sold directly to selected counterparts	Funds provided to IFAD by one lender
Negotiation process	Negotiated directly with investor counterpart with potential involvement of outside counsel and settlement agents	Negotiated directly with lending counterpart
Maturity	Tailor-made according to funding needs, more flexibility	Typically longer maturities than bonds, reduced flexibility
Interest Rate	Typically at fixed rates, more flexible to access lower rates for shorter maturities	Fixed or variable rate + reference rate (LIBOR/EURIBOR)
Trading	Trading can be contractually restricted	No trading
Settlement	Can be cleared or not through clearing houses, depending on nature of contractual restrictions	No settlement through third party

### C. Use of borrowed funds

23. **IFAD will manage borrowing through a balance sheet level ALM Framework.** The purpose of ALM is to ensure that liabilities are adequately managed (i.e. that debt is repaid on time). The need for active ALM arises from mismatches between the financial profile of assets and liabilities in terms of denomination currencies, maturities and interest rates. If such mismatches are not managed, these exposures can create liquidity constraints and shortages for an institution and, eventually, affect its capitalization.
24. IFAD's ALM Framework<sup>17</sup> was introduced to take a holistic approach to managing balance sheet risks. Within active ALM, the following two conditions set by the SBF and CPL Framework will continue to apply to all borrowed funds:
- **No earmarking.** In principle, a lender may not restrict the use of the funds being lent to IFAD (e.g. in terms of beneficiaries, purpose, theme or geographic area). Borrowing will continue to finance only IFAD's loan assets at the prevailing terms as set in the Policies and Criteria for IFAD Financing. However, in exceptional circumstances, a lender's proposal expressing a preference for a non-binding focus in a specific thematic area may be considered by the Executive Board as part of the approval process, provided it is consistent with IFAD's strategic priorities.
  - **Financial sustainability – borrowing will not be subsidized through core resources.** IFAD's ALM Framework and other financial policies will

<sup>17</sup> See document EB 2019/128/R.46.

determine the acceptable borrowing terms, with the aim of mirroring the concessionality of the loan assets to be financed. This approach takes into account any potential hedging costs to ensure that IFAD is immunized against any currency and interest rate risks. IFAD will target a positive margin over the lifetime of the borrowing, thereby avoiding subsidization through its core resources. If IFAD is unable to match the borrowing terms with the onlending terms, such borrowing will not be pursued.

25. **These conditions will apply irrespective of the allocation mechanism for borrowed funds.** Strategic decisions about a separate allocation mechanism to channel borrowing (e.g. to a specific income category) are not considered to be earmarking imposed by the lender. Financial sustainability will always be the first driver for any allocation mechanism or policy applied to borrowed funds.
26. **Enhanced measurement, monitoring and reporting will be implemented to support strengthened ALM.** As IFAD accesses a broader pool of lenders and a more diversified range of financial instruments and terms, more sophisticated ALM measurement, monitoring and reporting will be implemented. IFAD's balance sheet composition will be analysed through maturity and funding gap, repricing gap and duration/weighted gap reporting.
27. IFAD will apply its standard fiduciary policies for all borrowed funds to ensure that they are used for the intended purpose. No material additional burden in terms of verification, compliance or due diligence with respect to the use of borrowed funds may be imposed on IFAD by the lender.

#### **D. Borrowing governance**

28. **The authority to approve all borrowing proposals will remain with the Executive Board.** Recognizing that the IBF proposes to broaden the pool of eligible lenders, the Executive Board will retain the authority to approve all borrowing proposals. This will allow the Executive Board to maintain oversight over IFAD's borrowing activities and it will ensure that the Executive Board remains the appropriate authority to decide on IFAD's risk appetite, including reputational risk.
29. **Timeliness and flexibility are essential to seize the most favourable borrowing opportunities.** Since its first sovereign loan in 2014, IFAD has gained significant experience in the negotiation of loans under the SBF and the CPL Framework. This experience has made it clear that the ability to enter into agreements in a timely manner when the opportunity arises is crucial for an efficient funding strategy. Therefore, if the schedule of Executive Board sessions poses timing challenges with respect to mobilizing borrowed resources at favourable terms, Management may present confidential information on potential lenders and borrowing proposals for the Executive Board's approval on a no-objection basis by correspondence.
30. **IFAD's borrowing strategy will be operationalized through an annual funding plan approved by the Executive Board.** The total indicative borrowing envelope levels for a three-year replenishment cycle will be determined based on the target PoLG in the context of each replenishment consultation. Within those total borrowing levels, annual borrowing requirements will be represented in a funding plan that will be included in the RAC document. Both the funding plan and the RAC will be approved by the Executive Board every year. Annual borrowing amounts will be within the established maximum thresholds as reported in section III.E below. The funding plan will include details of the actual, committed, planned and new borrowing amounts as well as details about any lending counterparts and financial terms of the borrowing transactions.

#### **E. Borrowing limits and risk management**

31. **The IBF proposes to maintain the current borrowing limits and ratios.** IFAD's debt exposure is currently regulated by financial ratios included in the SBF.

These ratios will continue to apply to all borrowing on IFAD’s own balance sheet and will apply to current and prospective borrowing, unless amended by the Executive Board. The ratios and the thresholds are shown in table 3. The ratios and levels are deemed to be still adequate and in line with IFAD’s ambition for IFAD12.

Table 3  
**Financial ratios governing IFAD’s borrowing**

<i>Ratio</i>	<i>Formula</i>	<i>Threshold</i>
Debt coverage ratio	Total debt service (principal and interest)/Total loan reflows	< 50%
Liquidity ratio	(Cash in hand and in banks + investments)/Total assets	> 5%
Debt/equity ratio	Total outstanding debt principal/Initial capital available	< 35%

32. One change introduced by the IBF will be to recalibrate the computation of the debt/equity ratio to a more conservative and prudent level. It is proposed to align the calculation with the definition applied under IFAD’s Capital Adequacy Policy,<sup>18</sup> which aligns with industry best practice and is recognized in credit rating agencies’ methodologies.<sup>19</sup> This computation is somewhat more conservative; as an example, recalculating the debt/equity ratio as at 31 December 2019 results in a ratio of 9.8 per cent, whereas the current computation is 8.1 per cent.
33. **Since the introduction of borrowing in 2014, IFAD started actively managing its ALM exposure.** The SBF and CPL Framework describe how the risk introduced by borrowing, most notably the risk of mismatches between profiles of assets and liabilities, is measured and managed. All those provisions will continue to apply. So far, all borrowed funds have been onlent to loans denominated in the same currency, at higher interest rates and with remaining maturities at least as long as the loans being financed. This strategy de facto neutralized any mismatches between loan assets and liabilities and it will continue to be pursued to the extent possible during IFAD12. All proceeds from borrowed funds will be subject to the risk mitigation measures set out in this section.
34. **Financial risks will be managed at balance sheet level.** A more diversified financial profile of borrowing will be managed in line with the newly established ALM Framework. Building on the risk management guidelines described in the SBF and CPL Framework, the new ALM Framework introduced in 2019 builds on the strengthened financial architecture and risk management and prescribes risk indicators for monitoring and mitigating the major risks introduced by borrowing, i.e. liquidity, interest and currency risks:
- **Liquidity risk management.** The Liquidity Policy, which establishes the target liquidity level and the defined minimum liquidity that IFAD must hold to meet its obligations even in times of stress, inherently embeds all the cash flows related to borrowing. Liquidity planning, which will be integrated with the strategic planning process to ensure an adequate long-term liquidity and funding position, is an active risk monitoring and management tool.
  - **Interest rate risk management.** IFAD will strive to match, to the extent possible, the interest rates of its loan assets and related liabilities. To do so, it will employ, to the extent possible, interest rate hedging instruments to reduce its exposure and allocate capital to account for the residual unhedged interest rate risk.
  - **Currency risk management.** IFAD will continue to match, to the extent possible, the currency of its loan assets and related liabilities. It will employ, to the extent possible, currency hedging instruments to reduce its exposure

<sup>18</sup> See document EB 2019/128/R.43.

<sup>19</sup> This definition divides the outstanding principal amount by the initial capital available. The initial capital available is derived by subtracting from IFAD’s total equity the contribution receivables and promissory notes (net of provisions and qualified instruments of contribution) and adding the allowance for loan impairment losses.

to the risk of exchange rate fluctuations and allocate capital to account for the residual unhedged currency risk.

35. The ALM Framework will be operationalized through enhanced measurement, monitoring and reporting on all the risks mentioned above to ensure full compliance with IFAD's overall risk appetite, and to also ensure that IFAD remains able to provide flexible and competitive lending solutions for its borrowers.
36. **Capital planning.** Capital adequacy is an indicator of IFAD's solvency that measures its capacity to absorb potential losses derived from its development operations. It compares the level of capital available with the capital required to offset those potential losses. The projected level of deployable capital is essential to determine IFAD's risk-bearing capacity and leverage levels. Capital adequacy and liquidity are complementary and will be interlinked through the ALM Framework, which aims to minimize the residual exposure to non-core risks. The result of this dynamic relationship will determine the relevant limits of the yearly funding plan.
37. **Conflict of interest risk and reputational risk.** The Executive Board retains the right to approve whether a proposed lending counterpart is appropriate for IFAD. In addition, prior to submitting any proposal to the Executive Board, each potential lender will undergo IFAD's internal due diligence process based on the procedure followed for corporate private sector partnerships. This process entails a screening for any conflicts of interest and ESG performance of the potential counterpart. Specific financial aspects will be strengthened in this process, for example by including screening against anti-money-laundering policies, and verification of existing exposure of such lenders to other development institutions and ESG investments.
38. **Operational risk.** Operational risk related to the processing of increased borrowing transactions will be managed by upgrading internal accounting and payment systems, a process that has already begun. IFAD's financial model was upgraded in order to fully reflect borrowing transactions and related key metrics, and is undergoing further enhancement that will allow for more sophisticated reporting on current and forecasted ALM positions. IFAD's borrowing strategy is to increase leverage in a gradual and prudent manner, and the expectation is of a limited number of plain vanilla transactions per year.
39. **Legal risk.** As is standard in international financial markets, bilateral loan and bilateral bond agreements (and any hedging, services or similar agreements) with counterparts will be subject to national laws. Disputes may be submitted to arbitration under the rules of an acceptable tribunal, with any awards made to be final and binding. Management will conduct negotiations with the assistance of outside counsel, if appropriate, in the relevant jurisdictions. Nothing in the aforementioned agreements shall be deemed a waiver of IFAD's privileges and immunities.
40. **Road map and timeline.** Table 4 provides the road map and timeline for the review and approval by IFAD's governing bodies of the proposed IBF and the other actions envisaged by Management to enact the IBF in order to achieve the stated objectives.

Table 4

**Timeline for the review and approval of the IBF and expected next steps**

<i>Meeting/session</i>	<i>Action</i>
<b>Audit Committee 157<sup>th</sup> meeting</b> 18 June 2020	Submission of IBF for review
<b>Audit Committee 158<sup>th</sup> meeting</b> 1 September 2020	Submission of IBF for review
<b>Executive Board 130<sup>th</sup> session</b> 8–11 September 2020	Submission of IBF for review
<b>Executive Board 131<sup>st</sup> session</b> 7–9 December 2020	Submission of IBF for approval Presentation of the RAC including funding plan
<b>From Executive Board 131<sup>st</sup> session onwards</b>	Presentation of new potential lenders eligible under the IBF

\* As per rule 2 of the Rules of Procedure of the Executive Board, sessions of the Board shall be called by the President as often as the business of IFAD may require.

#### **IV. Specific provisions for borrowing from IFAD Member States and state-supported institutions through CPLs**

41. The terms and conditions for CPLs, introduced by the CPL Framework and set out in annex I, will remain applicable for borrowing from IFAD Member States and state-supported institutions through CPLs. The IFAD12 discount rates for calculating the grant element of CPLs provided in support of IFAD12 will be communicated during the replenishment process.



## Terms and conditions of the CPL Framework

- (i) **Maturity.** 25 or 40 years to match IFAD's blend and highly concessional terms.
- (ii) **Grace period.** 5 years for a 25-year loan or 10 years for a 40-year loan.
- (iii) **Principal repayment.** Principal repayment will begin after the grace period, applying a straight-line amortizing repayment schedule to minimize debt servicing costs to IFAD and closely match the repayment terms of IFAD blend and highly concessional loans: 25-year loan principal will amortize at a rate of 5 per cent per annum; 40-year loan principal will amortize at a rate of 3.3 per cent per annum.
- (iv) **Coupon/interest.** IFAD's CPLs will be modelled along similar lines to those of IDA. The IFAD CPLs would have an all-in special drawing right (SDR) equivalent coupon of up to 1 per cent. The difference between the coupon rate on the CPL and the country's target coupon rate (if higher) may be covered by an additional grant payment, as Member States would have the option of providing such an additional grant payment to bridge the difference between the target coupon provided by the framework and the desired coupon on the loan. CPLs with variable interest rates will not be accepted at this time, as most of IFAD's loans are in fixed rate terms.
- (v) **Interest rate floor.** If required, an interest rate floor will be applied for cases where the currency in which the CPL is provided determines a negative rate.
- (vi) **Prepayments.** In order to ensure IFAD's financial sustainability, IFAD may prepay the outstanding balance of the CPL, in whole or in part, without penalty.
- (vii) **Currencies.** IFAD will accept CPLs in SDR or any SDR basket currency (United States dollar, euro, Japanese yen, British pound sterling and Chinese renminbi). Subject to the foregoing, IFAD can accept CPLs in a currency other than the currency in which the core contribution of the Member State has been made.
- (viii) **Prioritization criteria.** To effectively manage the number and size of the potential CPL offers should they exceed IFAD's funding needs, offers will be evaluated according to the following criteria (in order of importance):
  - (a) **Currency:** preference will first be given to CPLs denominated in currencies about which IFAD has reasonable assurance that it can either hedge the loan or onlend the funds in the same currency.
  - (b) **Financial conditions:** preference will be given to CPLs that carry the most attractive financial terms for IFAD to assure maximum sustainability.
  - (c) **Size:** as IFAD seeks to minimize costs, preference will be given to the largest-sized CPLs.
- (ix) **Drawdown.** CPLs will be drawn down in three equal instalments over a maximum period of three years to allow IFAD to manage liquidity. At its discretion and with the agreement of the loan provider, Management may agree on single-tranche drawdowns if the lending partner so requests.
- (x) **Minimum amount.** Only CPLs of US\$20 million or greater will be considered.
- (xi) **Additionality.** Member States providing CPLs (directly or through a state-supported institution) will be expected to provide core contributions equal to at least 80 per cent of a minimum grant contribution benchmark and target a total grant equivalent contribution (which includes core contribution and the

grant element of the CPL) to at least their minimum grant contribution benchmark. The minimum grant contribution benchmark will be equal to 100 per cent of the average core contribution in local currency of the preceding two replenishment periods (for IFAD12, it would be the average of IFAD10 and IFAD11 contributions).

- (xii) **Effectiveness.** A CPL agreement between IFAD and the CPL provider (i.e. a Member State or one of its state-supported institutions) will be entered into preferably no later than the last day of the six-month period following the adoption of the IFAD12 Resolution, but at any rate not until the relevant Member State has deposited an instrument of contribution for the amount of its core contribution required under the provisions of paragraph (xi) above. In cases where a Member State plans to provide an additional grant to lower the coupon rate on the CPL, IFAD will require the payment of the additional grant as a prerequisite to accepting the loan disbursements from the CPL provider. This is to protect IFAD from paying a high borrowing cost on the CPL without receiving the related grant payment that ensures the required concessionality.
- (xiii) **Earmarking or restrictions on use of funds.** Since the primary purpose of CPLs is to finance IFAD's PoLG, earmarking or restrictions on use of funds cannot be accepted by IFAD. CPL resources will be allocated through the performance-based allocation system to Member States borrowing on terms comparable to or higher than those applicable to the CPL, as appropriate, therefore covering the whole set of lending products offered by IFAD. Notwithstanding the foregoing, it is expected that priority would be given to loans provided on highly concessional and blend terms.
- (xiv) **Grant element.** The grant element represents the present value of the financial benefit to IFAD of obtaining a CPL as opposed to a loan contracted on market terms. It is consequently the portion of the loan that is considered a grant for voting rights purposes to incentivize Members to provide such loans to IFAD. In the event of an additional grant payment, such payment will be incorporated into the loan amount and the grant element of the CPL will be calculated on the overall loan amount.
- (xv) **Voting rights.** The grant element of the CPL will entitle the Member State to voting rights under the same formula as applicable to replenishment contributions as stipulated in article 6, section 3(a)(ii) of the Agreement Establishing IFAD.
- (xvi) **Governance.** Before completion of negotiations, the detailed proposal of each CPL will be submitted to the Audit Committee for review and to the Executive Board for approval. CPLs would be subject to the same authorization process as followed for other borrowing arrangements under the Integrated Borrowing Framework.

## A. Determination of the grant element

1. While the full nominal amount of the CPL represents the financial resource for IFAD's PoLG, IFAD would attribute voting rights to Member States providing CPLs in an amount proportionate to the grant element embedded in the loans. The grant element of the CPL is the ratio of the present value of the debt service to the present value of the loan disbursements. The calculation formula is the same as that applied for the IDA18 CPL Framework, which is defined in the IDA18 Deputies' Report, as follows:

$$1 - \frac{\sum_{i=1}^n (DF_i \times CFS_i)}{\sum_{j=1}^n (DF_j \times CFD_j)}$$

Where:

$DF_i$  = Discount factor at period  $i$ , calculated using the discount rate of the CPL Framework;

$CFS_i$  = Cash flow from debt service at period  $i$ ;

$DF_j$  = Discount factor at period  $j$ , calculated using the discount rate of the CPL Framework; and

$CFD_j$  = Cash flow from loan disbursement at period  $j$ .

## **B. Additional considerations**

2. **Discount rate to calculate the grant element.** The discount rate calculation is important in that it determines the grant element, and therefore the allocation of votes for Members providing CPLs. For the IFAD12 CPLs, the method of calculating the discount rate used in determining the grant element will remain the same as the method approved for IFAD11, as described below.
3. **Net cost saving.** The methodology takes into account the possible savings over those borrowing transactions that have so far been concluded by IFAD, adjusted by a correcting factor to take into account the fact that IFAD may have borrowed so far at softer terms through the SBF than those possible on the capital markets.
4. To determine the appropriate discount rate to use, the assumed borrowing cost for IFAD was based on the most recent proxy of IFAD's funding cost of the Agence Française de Développement financing facility negotiated by IFAD, with the appropriate adjustments to take into account the longer maturity of the CPL. Because the facility was negotiated in the euro currency, IFAD's approach will move from the determination of a discount rate in euro as the starting point.
5. To convert the borrowing cost to a fixed interest rate, an interest rate swap in the euro currency with the relevant spread with the two proposed maturities was simulated.
6. A similar calculation was performed for the other four currencies against their appropriate short-term interest rate benchmarks. The weighted averages of the five currencies were then calculated to determine the discount rates in SDR terms.

## Comparison between the IBF, SBF and CPL Framework

1. Table 1 compares the main features of IFAD's current borrowing frameworks in terms of the five pillars that will be regulated through the IBF and highlights the changes that the IBF aims to introduce. Table 2 highlights the sections of the CPL Framework that will not be amended by the IBF and will therefore remain valid and deemed to be integrated in the IBF.

Table 1  
**Five pillars of the IBF: proposed innovations/updates**

	<i>SBF</i>	<i>CPL</i>	<i>IBF</i>
<b>Innovations:</b>			
A. Eligible lenders	<ul style="list-style-type: none"> <li>• Sovereign states</li> <li>• State-supported institutions</li> </ul>	<ul style="list-style-type: none"> <li>• Sovereign states</li> <li>• State-supported institutions</li> </ul>	<ul style="list-style-type: none"> <li>• Sovereign states</li> <li>• State-supported institutions</li> <li>• Multilateral institutions</li> <li>• Supranational institutions</li> <li>• Private institutional investors with a focus on impact investing</li> </ul>
B. Types of borrowing instruments	Bilateral loans	Bilateral loans	<ul style="list-style-type: none"> <li>• Bilateral loans</li> <li>• Bilaterally negotiated bonds</li> </ul>
<b>No change:</b>			
C. Use of borrowed funds	<ul style="list-style-type: none"> <li>• No earmarking by lender</li> <li>• No subsidizing from core resources</li> </ul>	No earmarking by lender	<ul style="list-style-type: none"> <li>• No earmarking by lender</li> <li>• No subsidizing from core resources</li> </ul>
D. Borrowing governance	Every proposal: <ul style="list-style-type: none"> <li>• Audit Committee for review</li> <li>• Executive Board for approval.</li> </ul>	Every proposal: <ul style="list-style-type: none"> <li>• Audit Committee for review</li> <li>• Executive Board for approval</li> </ul>	Every proposal: <ul style="list-style-type: none"> <li>• Audit Committee for review</li> <li>• Executive Board for approval</li> </ul>
<b>Updates from original SBF:</b>			
A. Eligible lenders	<ul style="list-style-type: none"> <li>• For Member States and state-supported institutions, at least 100% of core replenishment contribution R-1</li> </ul>	Not applicable	Disapplication of additionality rule
E. Borrowing limits and risk management	<ul style="list-style-type: none"> <li>• Debt/equity ratio</li> </ul>		Change in computation of debt/equity ratio

Table 2  
**Provisions of the CPL Framework integrated into the IBF**

<i>Provision</i>	<i>CPL Framework</i>	<i>IBF</i>
Discount rates and grant element	No change	Included with no change
Terms and conditions	Maturity: 25 or 40 years Grace: 5 or 10 years	Included with no change
Minimum amount	US\$20 million	Included with no change
Additionality	At least 80% of minimum grant contribution as core. Minimum grant contribution = 100% of average core contribution in local currency of R-1 and R-2	Included with no change
Effectiveness	After the Member State has deposited an instrument of contribution for the required amount of core contributions	Included with no change