

Document: EB 2020/130/R.35
Agenda: 9(f)
Date: 11 August 2020 **E**
Distribution: Public
Original: English



Investing in rural people

2020 Update to the Methodology for Determination of IFAD's Resources Available for Commitment

Note to Executive Board representatives

Focal points:

Technical questions:

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

Dispatch of documentation:

Deirdre Mc Grenra
Chief
Institutional Governance and
Member Relations
Tel.: +39 06 5459 2374
e-mail: gb@ifad.org

Executive Board — 130th Session
Rome, 8-11 September 2020

For: **Review**

Contents

Abbreviations and acronyms	i
Executive summary	ii
I. Purpose of the RAC	1
II. Goal of the review	2
III. Determination of RAC	4
IV. Conclusion	6

Annexes

I. Policy structure
II. Financial evolution of IFAD
III. Financing pillars
IV. RAC management – instruments

Executive summary

1. As indicated in the IFAD12: Business Model and Financial Framework 2022-2024, IFAD is implementing a series of financial reforms to maximize support for its beneficiaries while further reinforcing its financial profile. IFAD has introduced significant changes to its financial architecture including the sustainable replenishment baseline and Debt Sustainability Framework reform, Capital Adequacy Policy and an Asset and Liability Management Framework.¹ Key ongoing initiatives include the completion of the credit rating process, a revised Liquidity Policy and the introduction of the Integrated Borrowing Framework (IBF). This solid financial and risk management framework will ensure that IFAD remains a sustainable institution able to play an increasingly catalytic role in the global development arena, and will strengthen its ability to play a countercyclical role for its borrowers.
2. IFAD's commitment capacity as expressed in the Resources Available for Commitment (RAC) report constitutes a fundamental component of its governance process and financial and risk management framework. In line with the Agreement Establishing IFAD, it is the responsibility of the Executive Board to determine the proportion of the Fund's resources to be committed in any financial year, with due regard to the long-term viability of the Fund and the continuity of its operations.²
3. The primary determination of the RAC is made during the replenishment process, when Members agree on a target level for the programme of loans and grants (PoLG) for the related replenishment cycle, supported by a target replenishment. Once the target PoLG has been agreed, a yearly assessment of the RAC is a key control process to transparently report the intracycle status of actual resources. The RAC document, as approved by the Executive Board, reports on any significant deviations from initial projections so as to mitigate the underlying risk of overcommitment should future resources fail to materialize, or to ensure maximization of resource usage should additional unexpected resources materialize.
4. The current RAC methodology is based on IFAD's historical business and financial profile and focuses primarily on the commitment capacity to support new operations based on existing availability of resources and projections of future cash flows, so that the liquidity of the Fund does not fall below a minimum requirement within a horizon of 40 years. The aforementioned financial changes and in particular the expected reliance on increased borrowing of varying types and sources naturally require an update to the methodology used to determine the RAC,³ most notably by shortening the horizon of projections from the current 40 years, to provide accurate assumptions for projections.
5. The updated approach for defining the RAC makes a clear distinction between financing capacity and commitment capacity. Financing capacity means the available resources in the short term to fulfil existing operational commitments (e.g. disbursement of approved but undisbursed loans and grants or existing debt servicing).
6. While IFAD's financing capacity is determined chiefly by the minimum liquidity requirement articulated in the proposed update to the Liquidity Policy, commitment capacity – although equally dependent upon liquidity levels – requires strategic planning and functions as a control mechanism so that the PoLG remains stable and supported by IFAD's evolving financing capacity.
7. In sum, IFAD's updated RAC provides a more visible distinction between financing capacity and commitment capacity. This is achieved through a programmatic

¹ See document EB 2019/128/R.46.

² Article 7, section 2(b) of the Agreement Establishing IFAD.

³ Current procedures and definitions are included in EB 2013/108/R.20.

approach to its resources (namely traditional core resources and borrowing), with the ultimate goal of ensuring the sustainable implementation of the approved PoLG within each replenishment cycle, avoiding the risks of both unplanned adjustments and overcommitment. The updated RAC will provide additional transparency on the evolving financing capacity and source of funding (core versus external sources).

8. The implementation of the new RAC methodology will need to be coordinated with the timing of approval and implementation of the proposed update to the Liquidity Policy and of the IBF, both key pillars of the RAC. Once the updated Liquidity Policy and the IBF have been approved (envisioned for December 2020), and considering a 12-month monitoring period in 2021 of the underlying policies, the new RAC methodology will be fully adopted to determine PoLG approvals for the first year of IFAD12.
9. As such, and based on current funding assumptions, the RAC document to be submitted to the Executive Board in December 2020 to determine 2021 PoLG approvals will follow the current RAC methodology to avoid any disruption to IFAD11 programming.
10. The structure of this document is as follows: first, it provides a summary of the purpose of the RAC; second, it clarifies the objective of the review (complemented by information in annex II on the background of IFAD's financial trajectory and an explanation of sources and use of funds); and third, it presents the structure of the three-step process to assess IFAD's commitment capacity. Annexes III provides supporting details on the two fundamental pillars for managing IFAD's financial sustainability – liquidity and capital – and how resource planning is coordinated to support the RAC over different time horizons. Finally, conclusions are presented in section IV.

I. Purpose of the Resources Available for Commitment report

1. The main purpose of the Resources Available for Commitment (RAC) report is to serve as a key control tool to support planning within a given replenishment cycle by reassessing and communicating transparently the status of IFAD's financing capacity (liquidity position) and commitment capacity (liquidity and projections) for the following year. The goal is to avoid, to the maximum extent possible, intracycle adjustments that could disrupt operations.
2. The growing complexity of IFAD's financial profile and interlinkages between finance and operations necessitates strategic planning of resources and delivery. IFAD will continue to have a programmatic approach to delivery of the target programme of loans and grants (PoLG) agreed by Members during replenishment consultations and, through the updated RAC report, will closely monitor available resources and if needed adjust the level of new commitments accordingly.
3. The financial architecture reform IFAD initiated in 2018 is based on several key elements aimed at strengthening risk management, capital planning and the efficient use of different types of funding. These elements include: (i) the sustainable replenishment baseline; (ii) Debt Sustainability Framework (DSF) reform⁴; and (iii) a new prudent approach to leverage. Key pillars of this reform are the Capital Adequacy Policy,⁵ a proposed update to the Liquidity Policy⁶ and a proposed Integrated Borrowing Framework (IBF).⁷
4. All of the financial reforms serve the ultimate objective of maximizing financing to beneficiaries, while avoiding the erosion of liquidity and/or capital beyond a sustainable trajectory.
5. The elements of the reform converge on an assessment of IFAD's sustainable commitment capacity, or PoLG, over a given replenishment cycle. The target PoLG level agreed with Members is guided by the level of ambition and development impact that the Fund wants to achieve and represents a maximum level based on estimated resource flows. The target PoLG assumes that the target replenishment contribution level will be reached, that reflows will materialize and that a given level of borrowing will be secured during the cycle. The target PoLG level is determined under a rigorous approach in conformity with the financial policies approved by the Executive Board and operational parameters.
6. Once the target has been set for replenishment contributions, and required borrowing and target PoLG have been agreed during replenishment consultations, Management monitors contribution levels and the effectiveness of the replenishment.⁸ The first reassessment, or checkpoint, of the level of PoLG happens eight months into the replenishment cycle, based on the actual replenishment compared to the target, and compares the borrowing secured with the planned level of borrowing for the cycle.

⁴ See document EB 2019/128/R.44.

⁵ See document EB 2019/128/R.43.

⁶ See document EB 2019/128/R.47.

⁷ See document IFAD12/1/R.6, IFAD12: Strategic Directions.

⁸ The replenishment comes into effect when instruments of contribution or payments made have been deposited in an aggregate amount equivalent to at least 50 per cent of the pledges as communicated by the President to Members, six months after the adoption of the replenishment resolution.

II. Goal of the review

7. The principles of the new RAC methodology are in tune with the ultimate goal of ensuring IFAD's long-term financial sustainability through the effective management of its resources. Reaching this goal requires ensuring that the following objectives are fulfilled:
 - (i) Ensure donors' contributions are directed to the most needy beneficiaries, mainly in the form of grant financing;
 - (ii) Optimize the use of borrowing as an additional source of financing, managed prudently to avoid any extraordinary loss of IFAD capital but with sufficient flexibility to continue to serve as a countercyclical factor; and
 - (iii) Use financing resources with utmost transparency to serve past commitments and engage in future operations, attending to short-term financing capacity and long-term commitment capacity and mitigating the risk of overcommitment.
8. In addition, the current approach for determining the RAC has been revised to achieve more imminent and practical goals: (i) to align to and coherently implement the new financial reforms recently introduced; (ii) to overcome shortcomings of the existing approach introduced in 2013; and (iii) to balance the programmatic and financing elements of operations.

Alignment to new financial reforms

9. In view of its evolving financial structure and the introduction of borrowing as a funding source in addition to Member contributions, IFAD has begun moving towards a more dynamic resource optimization strategy that takes into account its hybrid financial structure. Borrowing now represents an increased proportion of the Fund's resources and is vital to ensure the financial sustainability of programmed levels of operations. The proposed new approach to the RAC embeds explicitly all the new elements of IFAD's financial profile as described in annex I.
10. The proposed new approach to measuring and defining IFAD's RAC incorporates the following key recent enhancements to IFAD's financial architecture:
 - (i) The sustainable replenishment baseline ensures that that non-recoverable expenses (operating costs and grants, including DSF grants) will not exceed contributions in each replenishment cycle.
 - (ii) **New approach to liquidity management**

In recognition of the decreasing trend in the organization's liquidity position, Management is proposing a new approach to liquidity management. This entails a move from liquidity projections based on future cash flows over 40 years to liquidity management focusing on the short term (effective liquidity position or stock approach to ensure ability to disburse and meet existing commitments).
 - (iii) **New approach to capital management**

In December 2019, IFAD adopted a new Capital Adequacy Policy. The approval of the policy laid the foundation for the capital management process at IFAD and marked the starting point for the integration of capital with other strategic financial policies, notably the Liquidity Policy. Capital adequacy measures will be used mainly to determine commitment capacity in the medium and long term as an optimal complementary tool of liquidity management (short and long term).

(iv) **Recognition of borrowing as a key component of resourcing**

As also evidenced in the Twelfth Replenishment of IFAD's Resources (IFAD12) scenarios included in the Business Model and Financial Framework 2022-2024,⁹ borrowing is expected to play a larger role over time to deliver the target PoLG,¹⁰ and should therefore be explicitly recognized. As part of the proposed IBF, IFAD will introduce an annual funding plan to be approved by the Executive Board. The funding plan is being introduced to provide more transparency regarding the status of existing borrowing and updated borrowing needs, and the related financial profile.

Enhancements to the current approach

11. The current approach to RAC focuses exclusively on long-term projections and disproportionately on new approvals, with less consideration of existing financial obligations. This exposes IFAD to the risk of overcommitment and puts further pressure on future needs to secure funding in subsequent years, as well as on liquidity in the short term.
12. The proposed new RAC methodology therefore anchors future commitment capacity for the new PoLG to current financing capacity, ensuring that existing obligations are financed as a prerequisite.
 - **IFAD's financing capacity** is the capacity to honour immediate existing obligations through the stock of available resources (liquidity position). In the short time, it will be guaranteed by respecting the minimum liquidity requirement, and implementation of the sustainable replenishment baseline will warrant that there is no erosion of liquidity as in the past.

Financing capacity relies only on existing funding sources. In particular, it accounts for the encashed proceeds of borrowing programmes.
 - **IFAD's commitment capacity** is the capacity to approve new loans and grants, for disbursement over a multi-year period. Commitment capacity is commensurate with changes in financing capacity, taking into account past and new financing and operational commitments. Any commitment capacity will also be supported by an assessment of capital availability for the planning period (at least two replenishment cycles) in line with the Capital Adequacy Policy.

Commitment capacity will be based on prudent resource projections. Borrowing included for assessing commitment capacity will be explicitly shown in an annual funding plan, which will be approved by the Executive Board as part of the RAC. The funding plan will also evidence the level of new borrowing needed to sustain the target PoLG and the updated status of and likelihood of IFAD securing that level of borrowing.

Balancing the programmatic and financing aspects of operations

13. Over the last decade IFAD has become a more complex and sophisticated development institution in terms of both operational and financial aspects. Its structure as a development finance institution, with respect to both sources and uses of financing, is gradually evolving over time. Borrowing is expected to play a larger role over time to deliver the target PoLG. Commitments on the use of core resources and an enhanced focus on IFAD's mission to help the poorest require close attention to planning various types of resources.
14. There is a recognized trade-off between the need to ensure solid long-term planning and the upfront availability of the full amount of resources required to deliver on a new target PoLG. The coordinated application and implementation of

⁹ IFAD12/2(R)/R.2.

¹⁰ Projected new borrowing needs for IFAD12 are between US\$1.0 billion and US\$1.375 billion

the new financial policy frameworks will ensure that IFAD resources are managed under a robust programmatic approach.

15. By integrating the RAC methodology with the new financial architecture, and in compliance with the new policies and frameworks, the programmatic approach to resource management will be based on the following implementation principles:
- (i) Strengthen the short-term planning and monitoring of available resources against immediate commitments, while ensuring long-term financial sustainability to support new engagements;
 - (ii) Extend the definition of resources to include changes in deployable capital available as a key metric to determine growth in IFAD’s balance sheet, including borrowing; and
 - (iii) Identify the increasing importance of borrowing as a systematic source of funding, and allow for proper debt planning and monitoring.

III. Determination of RAC

16. In line with the principles outlined above, Management will define prioritization rules for the implementation of the new RAC methodology based on a three-step measurement process, as follows:

- (i) First, **liquidity available (stock of liquidity)**. Only available funding sources will be used to assess **financing capacity**. This means that only encashed proceeds from contributions or existing borrowing will be considered.

The liquidity requirements and prudential ratios established by the Liquidity Policy will serve as key reference metrics for targeting and maintaining financing capacity, to ensure smooth disbursement of operations as planned.

- (ii) Second, **cash flow assessment and capitalization (projections)**. In order to determine IFAD’s commitment capacity in the form of the future size of the PoLG, Management will project a base-case scenario of cash flows, including assumptions for all variables, as replenishment contributions, loan and grant disbursements, growth in administrative expenses, reflows and planned borrowing. The different cash flows projected in the model are included in table 1, while annex II provides further details on the source of financing and use of funds.

Table 1

Main cash flows

<i>Cash inflows</i>	<i>Cash outflows</i>
Encashment of donor contributions and DSF-related contributions	Disbursements for DSF and regular grants
Loan reflows	Disbursements for loans
Investment income	Administrative expenses
Debt drawdowns	Debt servicing

The purpose of this step is twofold: first, projections will capture assessments of changes in liquidity levels in compliance with new requirements; second, they will incorporate the anticipated utilization of capital so that deployable capital always remains within acceptable levels, in accordance with the Capital Adequacy Policy and as agreed with the Board.

- (iii) Third, **availability of non-core resources**. In order to support the financing capacity and new commitment capacity, i.e. the new level of PoLG agreed by Members for a replenishment cycle, Management will assess the projected amount of borrowing that is needed based on the agreed replenishment target (i.e. the **borrowing needs**). This amount will be reassessed periodically in line with updated actual cash flows and updated projections of

all financial flows affecting the Fund. The **funding gap** is defined as the difference between the updated borrowing needs and the level of borrowing secured for the cycle.

As is common practice at other international financial institutions (IFIs), the proposed new RAC methodology will include a funding plan to provide greater transparency about the status of existing and future borrowing needs (see table 2). The funding plan will operationalize IFAD’s borrowing activity, distinguishing between stock and flow using the following key metrics:

- (a) **Existing/secured borrowing:** borrowing already drawn down or a committed loan or facility on which IFAD has a contractual right to draw down in the future.
- (b) **Planned borrowing:** borrowing that is planned to be secured where evidence of commitment is in place in the form of a letter of intent or framework agreement.
- (c) **New borrowing:** additional borrowing that is forecasted but not included in the following year’s RAC in the absence of certainty about the ability to secure it.

Table 2
Illustrative funding plan

Sample Funding Plan for IFAD12 - Amounts included for illustrative purpose								
	Actual		Forecasted					
	December 2021	2022				2023	2024	Total borrowing IFAD12
		Q1	Q2	Q3	Q4			
Funding gap beginning of period (borrowing needs) - (committed borrowing)								
Existing/Secured borrowing								
Planned borrowing								
New borrowing								
Outstanding borrowing (all replenishments)								

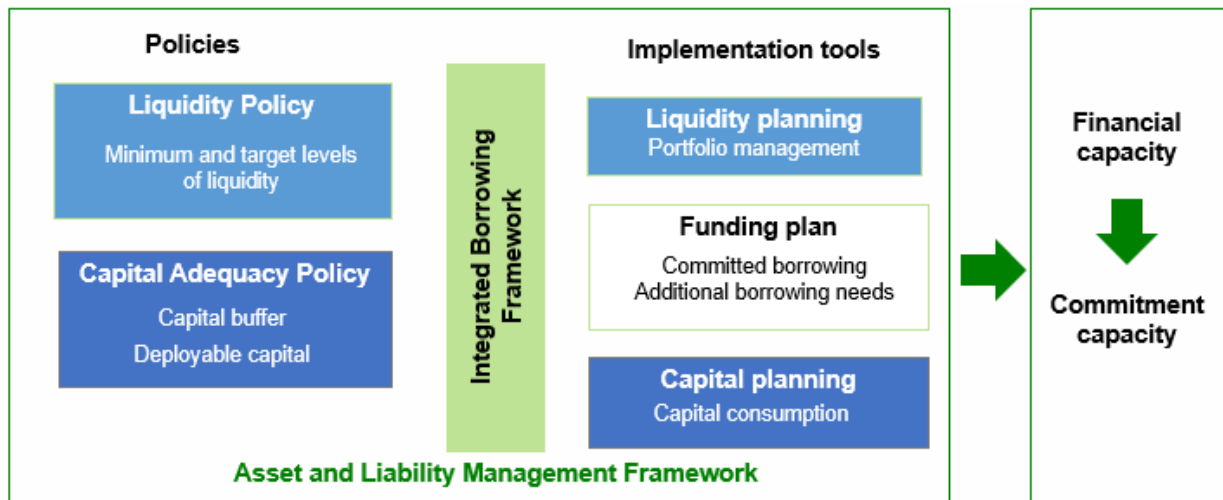
17. Management will inform the Executive Board of the status of borrowing secured and the amount of new borrowing needed. Should there be clear evidence, at the end of the second replenishment year, that the new borrowing is not expected to materialize before the end of the cycle and cannot be offset by other resource flows, Management will promptly inform the Executive Board of the need to adjust commitment and financing capacity accordingly through the RAC.
18. For the purpose of ensuring Management’s good governance of IFAD’s financial strength in the medium to long term, the new RAC methodology will include financial projections similar to those shown under the current approach, incorporating a detailed projection of cash flows from borrowing in a dedicated section.
19. The resilience of IFAD’s financing capacity will be evaluated periodically through stress testing in order to identify particular vulnerabilities that could affect its financing position. The stress test exercise will include a sensitivity analysis and scenario stress tests and will be conducted at least once a year to monitor how changes in the environment or IFAD's strategy might impact the prevailing liquidity and capital measures and to determine whether those measures remain appropriate.
20. Annex II presents background information on the key trends in IFAD’s financial profile since IFAD7 and the evolution of sources of financing and uses of funds; annex III also provides the financing pillars supporting IFAD financing and

commitment capacity (liquidity and capital), and annex IV includes the main instruments with different components and time horizons to support the RAC's financial planning.

IV. Conclusion

21. Management is committed to deliver the target PoLG agreed with its Members at the beginning of each replenishment cycle. The enhanced RAC will serve as the key control tool in providing a regular review of the key determinants of IFAD's commitment capacity, including the availability of borrowing and other net resource flows. Active portfolio management and programme planning will support an effective and financially sustainable operationalization of the PoLG, avoiding the need for severe intracycle adjustments and enhancing predictability.
22. The approach presented for determining IFAD's RAC provides a new proposition of updated principles and operating standards. The new approach takes into account the financial architecture reforms recently adopted or to be approved in the near future, notably the Capital Adequacy Policy, the new approach to liquidity management and the IBF. It also benefits from the experience acquired in recent years, including increasing limitations – notably with respect to the sources of financing and reliable, cost-efficient and timely availability of funding.
23. The RAC document will continue to be presented to the Executive Board for approval at the end of each calendar year in order to determine the maximum PoLG level for the subsequent year, with the ultimate goal of ensuring smooth planning towards the PoLG agreed for each replenishment cycle. The funding plan will be included in the RAC document so that Members can assess progress towards securing the borrowing needed for the replenishment cycle.

Policy structure



Financial evolution of IFAD, sources and uses of funds

Key financial trends

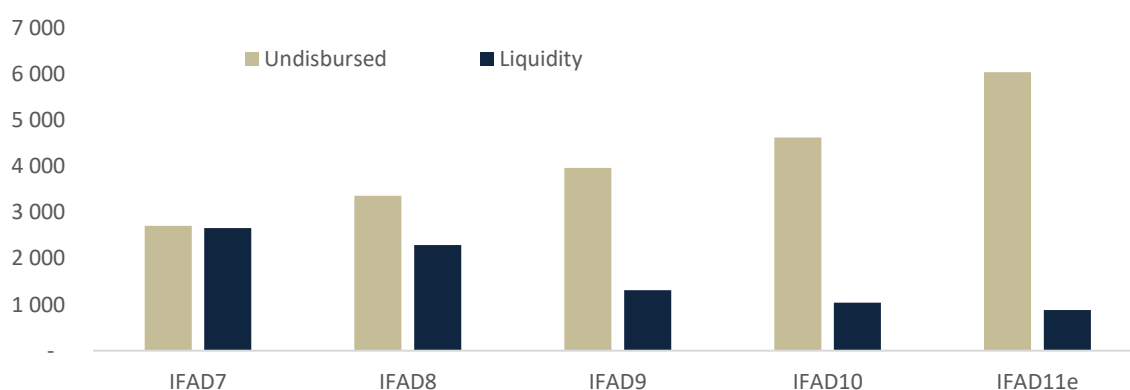
1. Since its founding, IFAD has been able to mobilize resources to achieve its unique mandate to assist the rural poor, contributing to reducing rural poverty, operating within a clear strategic framework and achieving a significant impact. Over the years of operations, IFAD has modified its approach to assist its recipient countries in response to the evolving rural development landscape and general economic conditions. At the core of its mandate and business model, IFAD's financing capacity needs to constantly be revised and strengthened to ensure the deployment of resources in a sustainable manner.
2. In response to donor's expectations and borrower needs, IFAD has gradually modified its financial trajectory as a result of two key drivers:

- 1) **Increase in engagements.** To give some context to the evolution of IFAD's financial profile mentioned above, IFAD's PoLG has grown significantly from US\$2 billion in IFAD7 to the current US\$3.5 billion in IFAD11, equivalent to a 75 per cent increase.¹¹

Cumulative PoLG for the period from IFAD7 to IFAD11 is estimated at US\$14.7 billion, approximately three times the amount of donor contributions (or \$4.6 billion).

This ambitious financing commitment, along with the implementation of other successful operational efficiency measures, has also resulted in a cumulative estimated disbursement amount of around US\$10 billion for the period IFAD7 to IFAD11. Notwithstanding this impressive amount of PoLG deployment, IFAD's current undisbursed portfolio is expected to reach approximately US\$6 billion by the end of IFAD11. This is six times the estimated liquidity position at the end of this replenishment cycle compared to similar levels in IFAD7 (see figure 1).

Figure 1
Evolution of undisbursed portion (or commitments) versus liquidity position



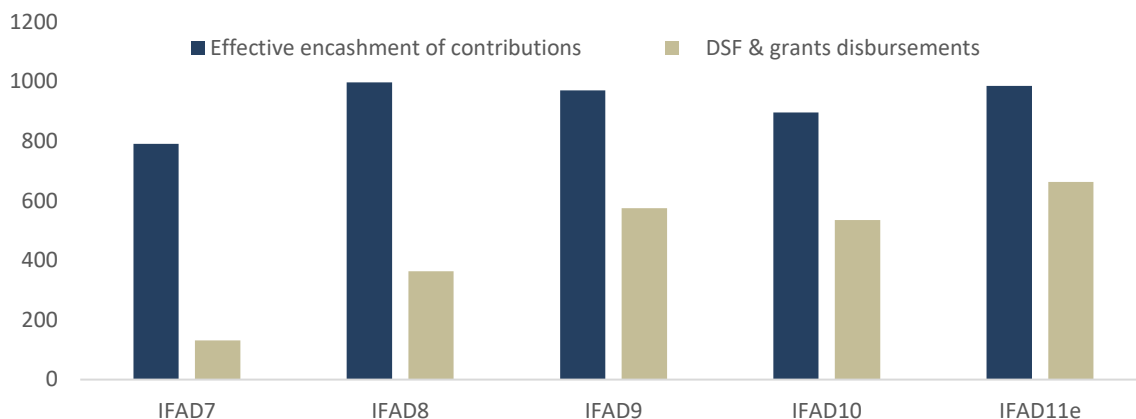
- 2) **Grant financing.** The second most critical change IFAD has experienced is the increase in grant financing since the inception of the DSF adopted by IFAD in 2007. DSF financing has provided substantial assistance to the most vulnerable countries in need that are at the core of IFAD's mission; however, the provision of grants against loans has reduced potential future reflows.

In line with the resources for grant-funded activities, grants disbursements represented approximately 6.5 per cent of IFAD's disbursements before IFAD7. Since the introduction of DSF, expenses related to DSF and grants

¹¹ It is important to note that when the last version of the RAC was adopted, the PoLG level was expected to remain at around US\$2.5 billion and to reach US\$3.3 billion only in IFAD15 when estimated regular contributions would reach around US\$2.5 billion.

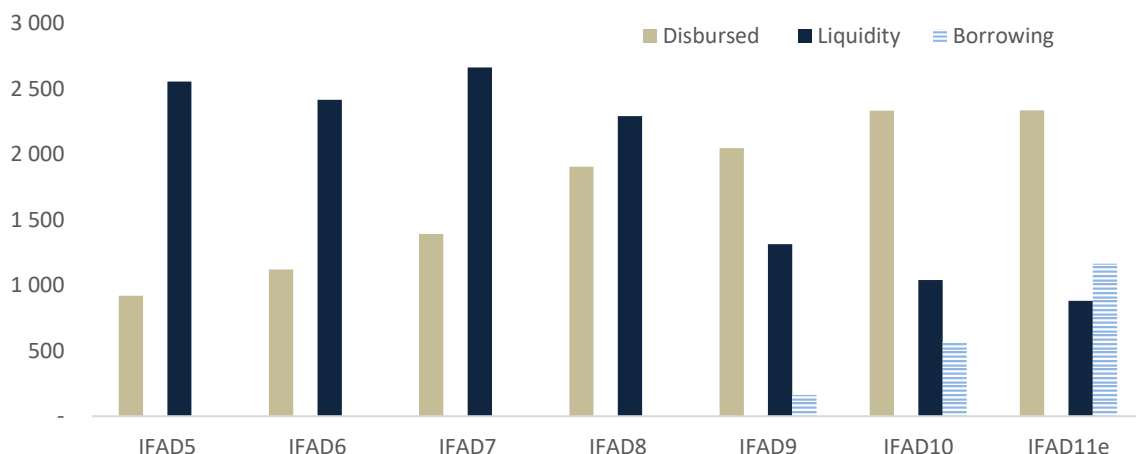
accounted for 17 per cent of total disbursements on average. Relative to the effective encashment, in IFAD7 grant disbursements accounted for approximately 15 per cent of effective contributions, rising to an estimated 65 per cent in IFAD11.

Figure 2
Evolution of disbursement of grants (regular and DSF) compared to effective encashment



3. A key element defining the transformation of IFAD's financial architecture has been the introduction of borrowing as the complementary source of funding to contributions and other core resources, namely reflows from loans. As seen in figure 3 below, while in IFAD7 liquidity was twice the level of outflows, since IFAD9 liquidity has been lower than commitments, declining in subsequent cycles with a higher reliance on borrowed resources to fund committed obligations.

Figure 3
Evolution of liquidity position and borrowing versus disbursements



4. The two trends above prompted several reforms to recalibrate IFAD's financial and business model. Two important independent reports confirmed the need for reinforcing the financial and risk management of the institution: the Independent Office of Evaluation of IFAD's corporate-level evaluation on IFAD's financial architecture in mid-2018 and the external independent assessment of IFAD's financial risk management in the second half of 2018.
5. In an awareness of the transformation needed, Management embarked on updating existing policies and building a new framework to strengthen its financial profile.
6. During the IFAD11 period, IFAD initiated the implementation of activities under the financial road map. The DSF reform, the Capital Adequacy Policy, the Asset and Liability Management Framework and the new approach to liquidity management are all new tools intended to preserve IFAD's commitment capacity and financial sustainability. During IFAD12, the Fund will continue to implement the agreed

actions to transform the financial framework that will be vital to deliver on the ambition of expanding its impact.

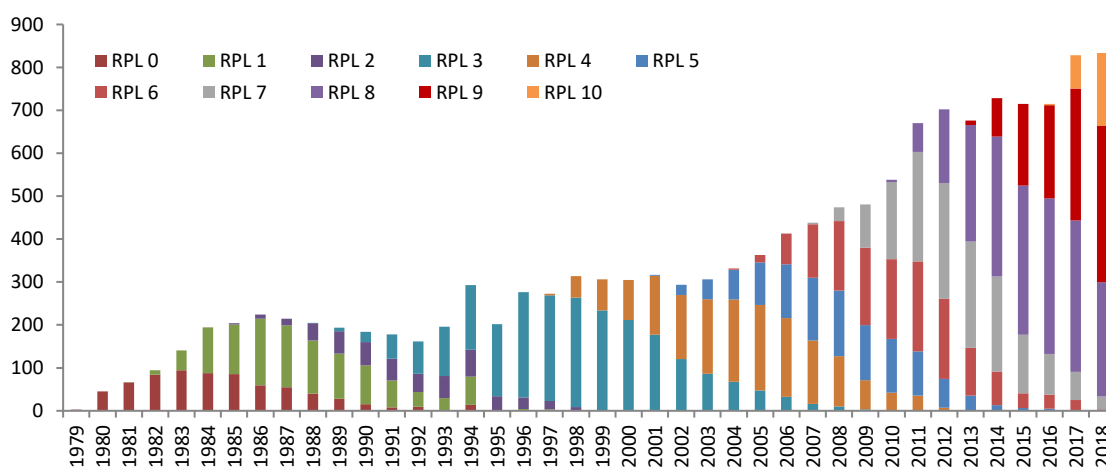
7. The consolidation of IFAD's transformation will be complemented by two major financial enhancements: the completion of IFAD's credit rating process; and implementation of the Integrated Borrowing Framework. In addition, the framework for accelerated repayments and voluntary prepayments will provide a new instrument to enlarge IFAD's commitment capacity. Enhancing IFAD's financial and risk management profile will strengthen its capacity to absorb losses and play a countercyclical role. Doing so will require concerted efforts by both Management and Member States to make IFAD a strong and financially sustainable development finance institution.
8. The ultimate goal of these policies is to enable IFAD to better fulfil its mandate through the effective and financially sustainable operationalization of its PoLG. Until now, IFAD's financial capacity was mainly focused on liquidity. With the introduction of borrowing, the need for an active and holistic approach to risk management became necessary to guarantee the institution's sustainability. IFAD is therefore transitioning to a more sophisticated financial structure focused on the fundamental pillars of capital adequacy and liquidity.
9. Even though leverage helps to increase IFAD's PoLG to levels beyond what would be possible if it were to rely solely on regular contributions, the amount of leverage is ultimately limited by the fact that the financial strength of any financial institution is assessed in the light of its level of capital and thus its ability to absorb potential losses from operations.
10. The continuity of the institution's operations is in the best interests of both donor and beneficiary countries. Donor countries are interested in optimizing the use of their regular contributions, while beneficiary countries rely on the institution's funding to finance programmes and projects to reach the poorest people in rural areas.
11. The availability of resources to support IFAD's mission is of utmost importance and must be based on a series of clear measures and definitions so that the evolution of financing capacity can be quantified and reported to Members in a timely and transparent manner.
12. To that end, it is important to note the evolution in IFAD's sources and uses of funding.

Source of financing

13. Since IFAD's inception, donor contributions have constituted the core source of financing. However, there are two broad sources of financing needed for IFAD to live up to its financing commitments.
14. **Core resources.** IFAD's financial architecture was initially centred on replenishment contributions and subsequently complemented with other non-reimbursable sources of funding, notably reflows from loans.
 - Replenishment contributions remain the core of funding for IFAD's operations and have stabilized since IFAD7 in the range of US\$1 billion to US\$1.5 billion.
 - Principal repayments from borrowers (or credit reflows) have increased substantially and now constitute the second largest source of financing, representing around US\$788 million in IFAD10 compared to US\$562 million in IFAD7 for an increase of approximately 40 per cent. From IFAD12 onwards, reflows are expected to be the largest source of financing.
 - Interest charges on loans also constitute an important source of financing for IFAD, averaging about 20 per cent of loan reflows by replenishment.

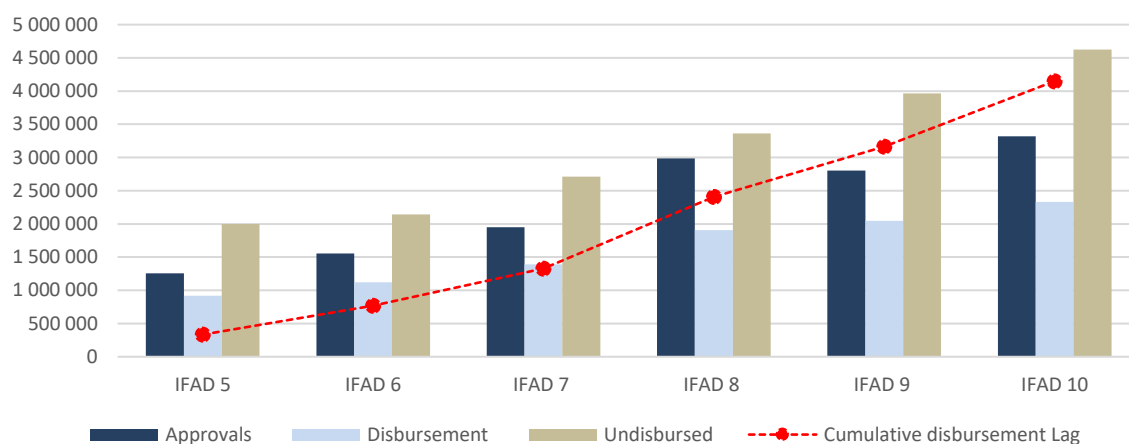
- Income from treasury investments is considered negligible and not a key component of IFAD's financing capacity owing to increased risk aversion – the decision not to expose IFAD to non-core risks such as market risk – and a challenging market environment for generating yields on conservative investments.
15. **External resources.** IFAD's outstanding engagements, or undisbursed loans and grants, have increased since IFAD7 and are considerable. Since IFAD9 borrowing has become an integral part of IFAD resources. For IFAD12, it is estimated that borrowing will provide almost 35 per cent of financing, compared to contribution encashments at below 30 per cent, constituting only the third source.
16. It is important to note that a portion of IFAD's commitments have been financed in the following ways:
- Deployment of unused resources.** IFAD has traditionally maintained a high level of liquidity. The gradual increase in commitments since IFAD7, while contributions remained steady, was financed in part with the large liquidity position maintained in the past. But whereas at the beginning of IFAD7 the liquidity position stood at around US\$2.5 billion against US\$1.4 billion in disbursements, it was only around US\$1 billion at the beginning of IFAD11 against estimated disbursements of US\$2.3 billion.
 - Frontloading.** The depletion of capital (or excess liquidity) is not the only explanation for the significant increase in resources. In line with the existing approach to cash flow projections, IFAD's business model has been partially sustained by the frontloading of future resources to commit new operations owing to the natural disbursement gap in operations.

Figure 4

Disbursement lag (annual disbursements by replenishment cycle)

17. Disbursement lag is defined as the time that elapses from the approval of a new operation to its disbursement. It is estimated that three and a half replenishment cycles are needed to fully disburse approved operations from a single replenishment. In effect, the portion of disbursement of the engagement of a replenishment has remained stable on average at 30 per cent since IFAD7. Cumulative disbursement lag from IFAD5 to IFAD10 is estimated at US\$4.1 billion (or 90 per cent of the undisbursed share at the end of IFAD10).

Figure 5
Cumulative disbursement lag and increase in undisbursed portion

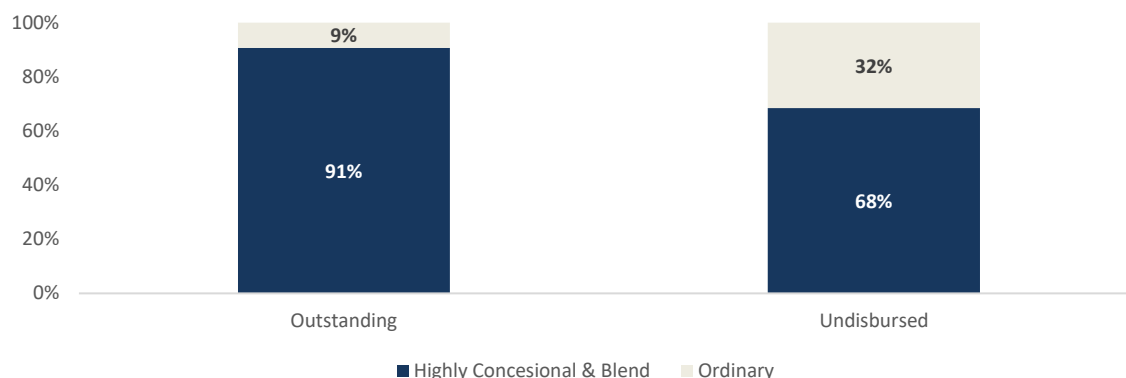


18. **Proposed new measures to expand commitment capacity.** In recent years IFAD has explored other ways of expanding commitment capacity, including:
- The introduction of an **accelerated repayments** clause in financing agreements to allow some borrowers to accelerate repayment of outstanding concessional loans if specific conditions are met. This clause will enter into effect during IFAD12. Additionally, a complementary framework has been proposed to allow the Fund, prior to IFAD12 and onwards, to provide financial incentives to eligible and creditworthy member countries that are willing to **voluntarily prepay** their outstanding highly concessional loans. This clause is standard at peer IFIs and its introduction in IFAD12 would allow the Fund to further harmonize its practices with those of other IFIs.
 - In recent years IFAD has been moving towards a more active portfolio management approach. This includes the monitoring and management of undrawn commitments, unused funds, expired loans and projects eligible for cancellation.

Use of resources

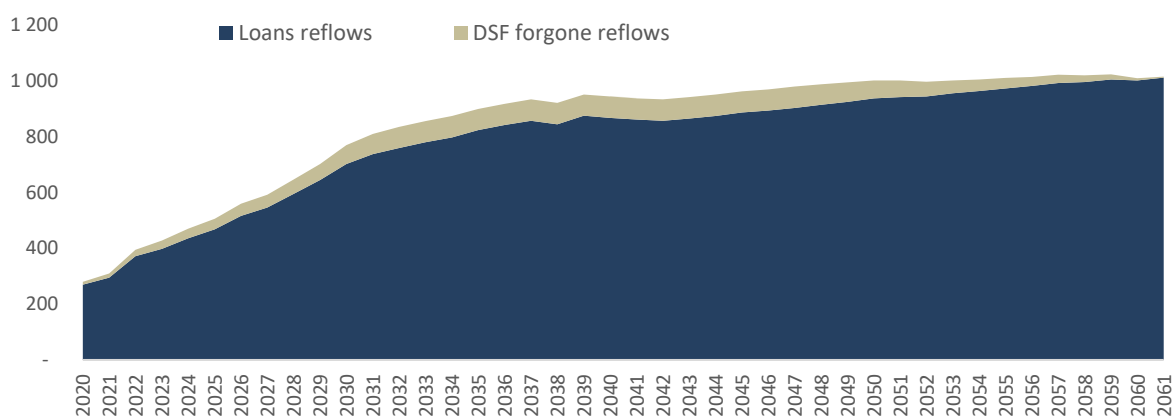
19. **Concessional loans.** Given IFAD's mandate, its loan portfolio shares some characteristics with those of other IFIs. IFAD's loan book is primarily characterized by concessionality, with 91 per cent of the portfolio composed of highly concessional and blend loans.
20. However, the trend in the portfolio will gradually change given the composition of the undisbursed loan portfolio, with 68 per cent highly concessional loans and 32 per cent ordinary loans. This is also a confirmation of the need for borrowing to enable disbursement of the undisbursed portion of non-highly concessional loans.

Figure 6
Distribution of outstanding portfolio versus undisbursed (in percentage)



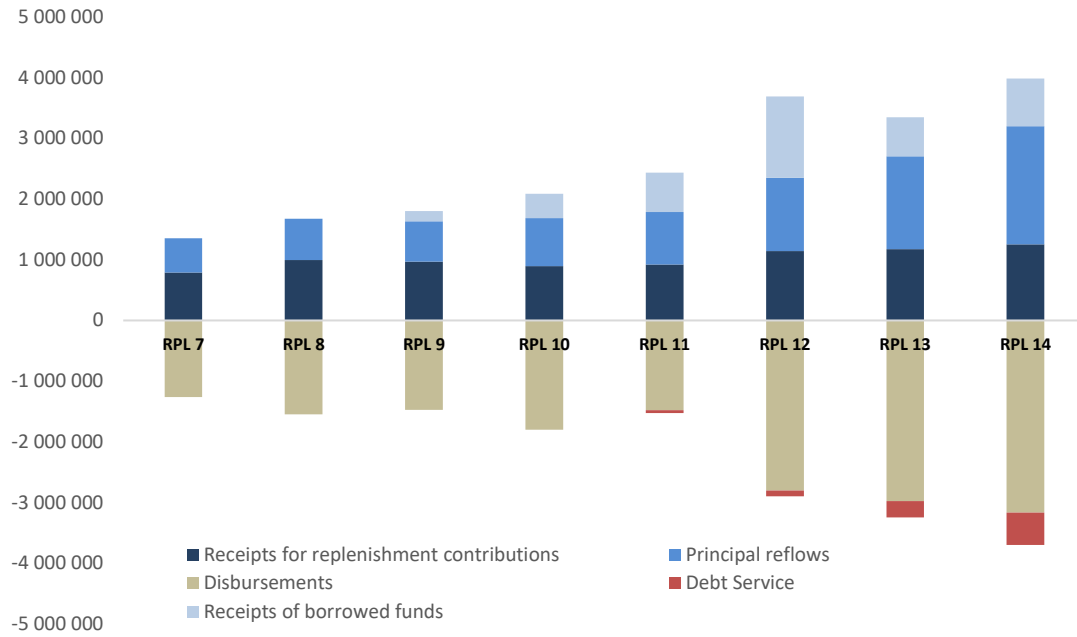
21. **Grants.** Part of the explanation of less highly concessional in the future is found in the change in economic conditions of some of IFAD's recipient countries, which are only eligible to receive grants. Since the introduction of the DSF, IFAD has committed US\$2.5 billion with the expectation that Members would compensate such amounts in the future with reimbursements over and above core resources. The absence of such reimbursements has had a significant impact on cash flow patterns. Crucially, the financial impact of the adoption of the DSF in 2007 has been twofold: first, it has resulted in the frontloading of IFAD resources to be compensated by encashments of contributions in future replenishments; second, it has reduced future credit reflows to sustain commitment capacity.

Figure 7
DSF forgone reflows



22. Ultimately, preserving IFAD's grant financing capacity was the motivation for revisiting the long-term financing framework. It is important to remember that in order not to erode IFAD's capital and financing capacity, grants funding must come solely from net replenishment contributions.
23. In short, as described in figure 8, IFAD's sources and uses of resources are expected to grow significantly in the next replenishment owing to previous ambitious programmes and the determination to continue to assist recipient countries at the same levels of engagement as in the last two replenishment cycles.

Figure 8
IFAD sources and uses of funds (estimates)



Financing pillars

Liquidity

1. The institution's liquidity level has been falling steadily over the last decade due to the ambitious operating targets. Conscious of this trend, in December 2019 Management presented the Approach to IFAD's New Liquidity Policy (EB 2019/128/R.47) to adjust to the emerging financial profile. The new approach calls for additional levels of liquidity with a revised target commensurate with an ambitious PoLG and consequent growing size of loans and grants approved and undisbursed, representing around 70 per cent of the disbursed portfolio.
2. More precisely, the new liquidity approach can be summarized in two broad principles: first, liquidity levels must always remain above annual commitments so that IFAD's engagement with recipient countries is covered in the short term; secondly, IFAD must build liquidity buffers to absorb any potential shock and ensure commitments are met in the medium term.
3. It is also important to note that the need for higher liquidity is a prerequisite for ensuring diverse sources of funding in the future to complement core resources. As IFAD depends more on lenders to resource its programmes, these perform strict due diligence processes to evaluate IFAD's financial profile, chiefly based on capitalization and liquidity. Possessing a credit rating would provide the highest reputable external opinion of IFAD's profile to lenders, hence enabling IFAD to expand its funding sources.
4. To ensure that liquidity is preserved, a short-term approach will be introduced to define the minimum liquidity to ensure that commitments for 12 months are covered with no additional source of funding. This will safeguard IFAD from any disruption of its core activities by ensuring annual disbursements as planned.
5. At the same time, target liquidity will serve to project borrowing activities and evaluate potential scenarios to avoid financing gaps due to a lack of liquidity and maintain sufficient funds to overcome periods of stress.
6. Liquidity is a measure related to the availability of resources to meet financial obligations as they mature. Liquidity management will provide a buffer for recalibrating financing and commitment capacity to redirect IFAD's financial sustainability trajectory at any point in time.
7. Capital adequacy (solvency) and liquidity are complementary, not substitutionary, and both are required to safeguard IFAD's survival and the fulfilment of its mandate in the short, medium and long term.

Capital

8. There are two main sources of capital for any development finance institution: (i) Member contributions; and (ii) internal capital generation (net income). An emphasis on one source over the other depends on the nature and strategy of each institution. Given IFAD's nature of providing primarily concessional loans and grants, its capacity to generate internal capital is limited, therefore equity needs to be recognized as the main constrained resource, and the principle of capital preservation (minimizing losses) must be a key element of its financial strategy along with the maintenance of new injection of capital contributions from Members.
9. According to IFAD's Capital Adequacy Policy approved by the Executive Board in December 2019, deployable capital is the main metric for assessing IFAD's capital utilization and the availability of resources to support future operations. Deployable capital is proposed as the main measure to assess IFAD's capital utilization and the availability of resources to support future commitments.
10. To determine the dynamics of deployable capital, it is imperative to assess changes in total initial capital available, or total equity minus contributions and promissory

notes receivable plus allowance for loan losses. The second key metric to evaluate deployable capital is total resources required, or aggregate capital requirements given IFAD's risk exposure (credit risk, market risk, fair value adjustments, etc.). Finally, in accordance with the policy, a buffer needs to be maintained (in the form of a percentage of initial capital available) to overcome any sustained unexpected stress events not captured by economic capital measures. The buffer can also play a countercyclical role.

11. Capital adequacy is a fundamental indicator that measures IFAD's capacity to absorb potential losses derived from its operations. It compares the level of capital available with the capital required to offset potential losses.
12. The capital planning process relies on IFAD's projected balance sheet, which is determined based on assumptions intended to reflect the most accurate view of the Fund's long-term strategy and pipeline of operations. In light of the above, and considering the long-term nature of IFAD's operations, the assumptions underlying these estimates must be reviewed periodically to ensure that corrections can be made in a timely manner to avoid a breach in financial limits established by the Executive Board.
13. In the medium term, resources available for commitment will be determined based on the projected trajectory of IFAD's deployable capital and compliance with the sustainable replenishment baseline principle, which will contribute to IFAD's capital preservation. Given IFAD's nature of providing concessional loans and grants, IFAD's main constrained resource is capital, and the principle of capital preservation (to minimize losses) must be a key element of its financial strategy along with the maintenance of regular Member contributions.
14. Key elements of IFAD's capital preservation are:
 - **Sustainable replenishment baseline.** All projected replenishment scenarios should cover at least: (i) the timely reimbursement of forgone principal reflows from approved DSF commitments falling due during the replenishment cycle; (ii) the pre-financing of new DSF commitments; (iii) the regular grant programme; and (iv) operational expenses. Only if the replenishment exceeds the sum of these amounts will IFAD have new funds to address the risks embedded in its new lending operations.
 - **Borrowed resources.** IFAD's financial planning will take into consideration the ability to cover debt service given the implications in terms of liquidity, solvency and other related risks. The cost of borrowing must not be such that it could erode IFAD's capital or create additional Member contribution requirements.
 - **Operational expenses.** Optimizing operational costs will affect IFAD's equity. Any management plan to increase operational efficiency will improve the capital ratios, while any increase in costs will affect capital ratios adversely. Financial projections should incorporate any material assumption affecting IFAD's operational cost behaviour.

RAC management – instruments

<i>Approach</i>	<i>Planning horizon</i>	<i>Objective</i>	<i>Key variables</i>
Short-term liquidity requirement	12 months	Liquid assets capacity to cover short-term financial commitments	Short-term inflows: Contributions, loan reflows, investment income, encashment of committed borrowing
	24 months	<i>(as prescribed by IFAD's Liquidity Policy)</i>	Short-term outflows: Loans and grants disbursements, administrative expenses, debt service, other outflows
Long-term liquidity planning	1 to 3 replenishment cycles	Assessment of the projected liquid assets capacity to cover financial commitments over the long-term projected horizon <i>(RAC as control tool)</i>	Inflows and outflows: Projected long-term inflows and outflows from core resources Funding plan: Identification of new borrowing needs to be covered by the incorporation of planned borrowing and new borrowing
Capital planning	1 to 5 replenishment cycles	Assessment of IFAD's risk-bearing capacity ¹² <i>(as prescribed in the Capital Adequacy Policy)</i>	Sustainable replenishment baseline: Contributions coverage of at least all non-recoverable expenditures (regular and DSF grants and operational expenditures) Projected capital consumption: Derived from projected balance sheet and committed off-balance sheet positions, mainly a result of the interaction of lending volumes, lending terms (concessionality) and country of exposure (rating)

¹² Amount of risk IFAD can take on, determined as a function of available capital against potential losses derived from development-related operations