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Investing in rural people

# Update to IFAD's Financing Conditions

**Note to Executive Board representatives**

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# Contents



**Annexes**

## Abbreviations and acronyms

| | |
|---|---|
| GDI | graduation discussion income |
| GNIpc | gross national income per capita |
| IBRD | International Bank for Reconstruction and Development |
| IFAD12 | Twelfth Replenishment of IFAD's Resources |
| LIC | low-income country |
| LMIC | lower-middle-income country |
| PCIF | Policies and Criteria for IFAD Financing |
| UMIC | upper-middle-income country |

## Definitions

**IFAD concessional loans.** All loans provided with a high level of concessionality. For the Twelfth Replenishment of IFAD's Resources, IFAD concessional loans consist of the loans provided on super highly concessional, highly concessional and blend terms.

**IFAD semi-concessional loans.** All loans on ordinary terms.

**Borrowed resources.** Funds that IFAD borrows from any source, including bilateral loans, sovereign agencies and social impact investors, as well as reflows from loans sourced by the aforementioned resources.

**Core resources.** Replenishment contributions, concessional loan reflows and concessional loans (e.g. concessional partner loans).

## Recommendation

The Executive Board is invited to approve the update to IFAD's financing conditions as reflected in paragraphs 11 and 18 of the present document (main report). The updates to IFAD's financing conditions will come into effect from when the legal amendments are duly approved by the related governing bodies.

# Executive summary

1. IFAD is undergoing a financial transformation to enable the Fund to increase its financial resources by optimizing the use of different sources of funding, and of borrowing in particular. This will allow IFAD to continue engaging with Member States in a mutually sustainable manner, thus growing financial support to reduce poverty in the most vulnerable rural areas.

2. Mutually sustainable development financing requires differentiated financing conditions, reflecting the different development stages of borrowers, while ensuring systematic recovery of the cost of funding. The updated financial conditions are still favourable to countries at a more advanced stage of development on terms that remain competitive compared to market financing options (e.g. bond issuance).

3. IFAD has already introduced differentiated financing conditions, starting in 2019. Building on the second pillar of IFAD's Revised Approach to Graduation, agreed during the Consultation on the Twelfth Replenishment of IFAD's Resources (IFAD12), and the ongoing discussions on the access to future borrowed resources (i.e. the Borrowed Resource Access Mechanism), Management is exploring and simulating how these proposals would translate into a possible update to IFAD's financing conditions by introducing the changes below:

   - Updating IFAD's current categories to reflect the pricing changes for upper-middle-income countries (UMICs) above and below graduation discussion income (GDI); enabling a new set of low-income countries (LICs) and lower-middle-income countries (LMICs) for the first time to access additional funds on semi-concessional loans but at a pricing lower than for higher-income countries;
   - Introducing a differentiation in access to maturity and grace periods for IFAD's loans depending on the gross national income per capita (GNIpc) of borrowers so that higher levels of concessionality are provided to countries most in need.

4. The above proposals were formulated in consideration of two major concepts:

   - **Differentiated financing conditions.** Financing conditions will continue to be differentiated according to countries' economic trajectories so that UMICs with a GNIpc above the GDI threshold pay more than those below, while UMICs pay slightly more than LICs and LMICs. UMICs will have restricted access to longer maturities to ensure that lower-income countries have higher levels of concessionality. The pricing will ensure IFAD's attractiveness compared with countries' market financing options.
   - **Financial sustainability of IFAD.** IFAD should ensure that the average onlending price is higher than IFAD's average cost of borrowing.

5. This document focuses on the changes above and the current methodology based on a lending spread and a maturity premium will continue being in place. Management expects to continue to reflect IFAD's current pricing[1] structure in IFAD12, ensuring financial sustainability.

[1] Currently, IFAD mirrors the structure of pricing of loans on ordinary terms issued by the International Bank for Reconstruction and Development (IBRD).

6. The proposed update of IFAD’s financing conditions will not involve a major change in business processes such as loan administration, accounting and systems, and/or a need for additional internal resources. The proposed changes will be implemented through a roll-out plan with dedicated internal and external communications.

7. This document proposes a set of flexible principles and actions updating IFAD’s loan financing conditions, and provides an example for illustrative purposes only. Management presented this document for discussion at the informal seminars held in October 2020 and January 2021. It is being presented in April 2021 to the Audit Committee for review and to the Executive Board for approval.

# Update to IFAD's Financing Conditions

## I. Background and approach

1. During the IFAD12 Consultation and discussions around (i) the principles for accessing future borrowed resources (i.e. the Borrowed Resource Access Mechanism) and (ii) IFAD's graduation approach and its four pillars, Management agreed with IFAD stakeholders to propose further elements of differentiation in IFAD's financing conditions. It was agreed that these elements will be presented to the regular governing bodies in keeping with the current delegation of authority and as part of systematic updates foreseen in the Fund's financing conditions.[2] It was also agreed that these conditions, and the pricing to be applied for borrowed resources, will ensure that IFAD is able to recover the costs of funding to maintain its own financial sustainability while remaining attractive compared with market financing options (e.g. bond issuance).

2. In charting its IFAD12 road map, Management has highlighted how "IFAD's universal client base represents a key operational and financial strength, and borrowed resources can be used to finance not only projects in UMICs, but also a significant share of LMICs and selected LICs borrowing at semi-concessional terms''.

3. In preparing the inputs for this document, Management has made efforts to:
   - Ensure a sustainable differentiation of the financing conditions of the borrowers, recognizing their development transitioning and fragility;
   - Enhance IFAD's financial discipline and sustainability by ensuring that onlending rates are higher than borrowing costs, thus passing the cost of funding to borrowers;
   - Ring-fence the changes to the semi-concessional loans funded by borrowed resources while safeguarding the high level of concessionality of concessional loans funded by core resources.

4. The scope of this proposal covers the financing conditions of IFAD semi-concessional loans to be provided to sovereign borrowers in the context of IFAD projects and programmes. It excludes transactions under the private sector framework and those with subnational entities.[3] In addition, the development of future operational instruments may require the application of specific financing conditions to be approved by the appropriate governing bodies.

## II. Scope of the changes discussed at replenishment

5. The proposed changes will determine: (i) the definition of new categories and a consequent update of the differentiation of maturity premiums by income category; (ii) the introduction of differentiation in access to maturity and grace periods for IFAD loans according to the GNIpc of borrowers, so that higher levels of concessionality are provided to countries most in need.

## III. Changes on the adjustment to the standard maturity premium between income categories for IFAD loans

6. Effective from 2019, IFAD introduced premium differentiation for borrowers eligible for ordinary term loans. This took account of a country's per capita income or classification, based on the IBRD principles of classification and pricing.

[2] Update of Financing Terms (EB 2018/125/R.45/Rev.1).
[3] As defined by the Approach Paper: Lending to Subnational Entities in the Context of IFAD's New Business Model (EB 2020/129/R.23).

Consequently, a borrower may be eligible for an exemption or discount, or subject to a surcharge (see annex I).

7. The current definition of the different categories by income does not fully reflect all the elements of accessing borrowed resources nor the modified differentiation discussed during the IFAD12 Consultation. The limits of the current definition of categories are:

- Current category B classification, benefiting from a discount, includes a broad range of LMICs and the UMICs below GDI threshold. It means that, currently, IFAD offers the same financing conditions for a group of LMICs and UMICs.
- Category D, in its current definition, would not be applicable from IFAD12 onwards.
- Selected LICs and LMICs, initially eligible only for concessional loans, will have access to future borrowed resources. At present, IFAD does not have a category for these groups of countries. Access to such resources should be on more favourable financing conditions than the creditworthy LMICs and UMICs, eligible by definition for IFAD semi-concessional loans.

8. Therefore, it is proposed to adjust the definition of the income category differentiation for IFAD loans to be approved from 1 January 2022 onwards. The proposed approach maintains the current structure based on four types of borrower categories, albeit tailoring the differentiation more inherently to IFAD's specificities and strategies, including its proposed approach to graduation.

9. The proposed structure of this categorization is designed to:

(i) Incorporate a specific category for LICs and LMICs eligible for IFAD concessional loans, which are at low or moderate risk of debt distress and may request additional financing on a semi-concessional basis;

(ii) Assist borrowers in their expected development trajectory and transition status, as reflected in their GNIpc and other macroeconomic indicators;

(iii) Discontinue a category should it be considered as no longer eligible for IFAD financing under the proposed graduation approach.

10. The outcome aims to safeguard the principle that lower-income countries pay less than higher-income countries and benefit from higher levels of concessionality.

11. In order to reflect the latest discussions on graduation and related financial pillars, it is proposed that IFAD borrowers eligible for IFAD loans on a semi-concessional basis be classified into one of four groups:

- **Category 1,** to include **LICs and LMICs eligible for IFAD concessional loans. These countries will, in addition, now be able to access semi-concessional loans**. They will be subject to standard premium maturity differentiation, which will ensure a minimum recovery of IFAD's costs of funding from borrowed resources.
- **Category 2,** to include **LMICs non-eligible for category 1** (already accessing semi-concessional loans), borrowers **transitioning, creditworthy fragile and conflict-affected states and small state economies irrespective of their GNIpc**. These countries will be subject to a premium maturity higher than category 1.
- **Category 3,** to include **UMIC borrowers with a GNIpc below GDI threshold** which do not qualify for an exemption listed in category 2. These countries will be subject to a premium maturity higher than category 2.
- **Category 4,** to include **UMICs with GNIpc above the GDI threshold**. These countries will be subject to a premium maturity higher than category 3.

Table 1
**Comparison of current and proposed definition of premium maturity differentiation by income category for IFAD loans**

| *Income category* | *Current composition* | *Proposed composition* |
|---|---|---|
| **Category A (current)/1 (proposed)** | (i) Borrowers transitioning from blend terms to ordinary terms during the replenishment period in which they transition and the next replenishment period<br>(ii) Fragile and conflict-affected states<br>(iii) Small state economies that are eligible for IFAD semi-concessional loans<br>(iv) During IFAD11, Member States that became eligible for ordinary terms in IFAD9 or IFAD10 | LICs and LMICs eligible for IFAD concessional loans, which can access IFAD semi-concessional loans from borrowed resources |
| **Category B (current)/2 (proposed)** | Countries with a GNIpc less than or equal to US$6,975 (GDI threshold) | (i) LMICs non-eligible for category 1<br>(ii) Borrowers transitioning<br>(iii) Creditworthy conflict-affected states and small state economies irrespective of their GNIpc |
| **Category C (current)/3 (proposed)** | Countries with a GNIpc above US$6,975 and less than US$12,375 (high-income countries threshold) and not eligible for category A or B | UMIC borrowers with a GNIpc below GDI |
| **Category D (current)/4 (proposed)** | Countries with a GNIpc greater than US$12,375, unless they are eligible for an exemption as described above | UMICs with GNIpc above the GDI threshold |

12. IFAD will continue applying the transition framework's principle of predictability for any change of income category during the replenishment cycle. This means that the maturity premium differentiation will be established at the start of a cycle for all borrowers and no hardening of the premium will be effected during a cycle. Reversals to a lower-income category or exempted category will, instead, continue to be applied on an annual basis and become effective from the beginning of the following financial year.

13. In addition, and as currently applicable, the income category differentiation applicable at the time of approval of the financing agreement will remain unchanged for the entire life cycle of the loan repayment.

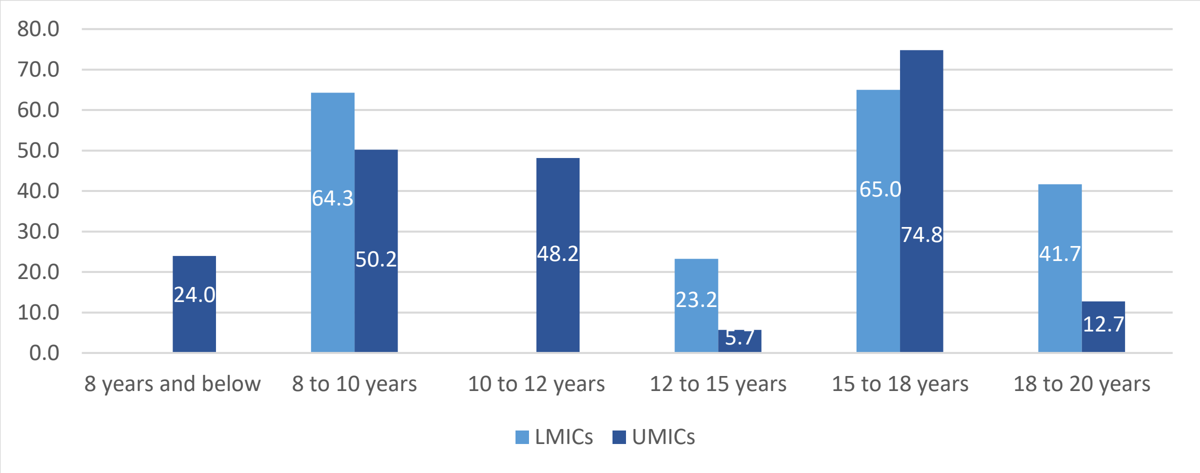
# IV. Differentiation of access to maturity and grace periods by income category

14. Currently, IFAD semi-concessional loans offer a variable maturity and grace period, at the choice of the borrower, subject to a maximum of 35 years' maturity and 10 years' grace period, with an overall maximum average repayment maturity[4] of 20 years. This change in maturity and grace periods was introduced for loans approved since 1 January 2019.

15. Figure 1 reflects the trend of demand from borrowers in terms of maturity and grace period for ordinary term loans approved between 1 January 2019 and 31 August 2020. Demand from LMICs tends towards a longer maturity period despite the higher spread, with 67 per cent (US$130 million) of the overall loans approved for LMICs. While for UMICs, demand varies between the set of maturities – the highest demand categories are for maturities of between 15 and 18 years (45 per cent, or US$98 million) and maturities of between 23 and 30 years (35 per cent, US$75 million).

[4] The average repayment maturity is the sum of the weighted average repayments of principal over the repayment period (the time between the end of the grace period and maturity). It is dependent on the maturity and grace period chosen by the borrower.

Figure 1
**IFAD11 loans approved on ordinary terms by average maturity and income category as of 31 August 2020**




16. For many LMICs and LICs that will be eligible to call on additional financial support from IFAD borrowed resources, the institutional environment and access to capital for sustainable development is often limited. While for the above-GDI countries, the attractiveness of official development assistance with a lower level of concessionality, which applies to IFAD resources, tends to decrease as incomes rise.[5]

17. IFAD will continue tailoring the conditions of its financial instruments to individual countries' or country groups' economic circumstances, debt management capacities and ability to access significantly larger resources from financial markets on reasonable terms.

18. The proposed approach introduces differentiated access to longer maturities of IFAD loans for borrowers, depending on their level of GNIpc (please see annex II, table 1):

- **LICs and LMICs initially eligible for IFAD core resources in concessional loans will be eligible for IFAD semi-concessional loans, subject to a maximum of 35 years' maturity and 10 years' grace periods, with a maximum average repayment maturity of 20 years.**
- **LMICs initially eligible for IFAD semi-concessional loans**, **creditworthy UMICs classified as fragile and conflict-affected, small state economies and borrowers in transition** will have access to resources subject to **a maximum of 30 years' maturity and eight years' grace period, with a maximum average repayment maturity of 18 years.**
- **UMICs** with a **GNIpc below the GDI threshold**, and not classified as category 1 or 2, will have access to resources subject to a **maximum of 20 years' maturity and five years' grace periods**.

[5] A desk review conducted by IFAD Management on the International Debt Statistics database shows that most countries with GNIpc above the GDI rely much less on multilateral and concessional debt. According to 2020 World Bank debt statistics data, with the exception of Botswana (79 per cent), 16 countries for which GNIpc exceeds GDI have on average 7 per cent of multilateral debt (based on a percentage of total external debt). Their portion of concessional debt (defined as loans with an original grant element of 25 per cent or more, based on a percentage of total external debt) is 0.4 per cent on average. This is markedly different from the 26 countries that are eligible for IBRD loans but have not yet reached GDI. They have 17 per cent of multilateral and 5.2 per cent of concessional debt on average.

- **UMICs** with a **GNIpc above GDI**, and not classified as category 1 or 2, will have access to resources subject to a **maximum of 18 years' maturity and three years' grace period.**

19. It should be noted that these changes reflect, for the UMICs above GDI, the same maturity and higher grace periods that IFAD offered prior to updating its financing conditions in 2019. In addition, limiting access to longer dated loans in turn acts as an asset and liability management mechanism, reducing the need to borrow extensively at longer maturities, which are more expensive and would also impact IFAD's overall cost of borrowing.

# V. Amendments to IFAD legal documents

20. The Agreement Establishing IFAD and the Policies and Criteria of IFAD Financing (PCIF) set out the roles and responsibilities of IFAD's governing bodies for policies regarding financing by the Fund as follows:[6] "The Governing Council, while retaining its authority to establish the broad policies, criteria and regulations that govern financing by the Fund, acknowledges that the Executive Board has the primary responsibility to set out the detailed policies governing such financing".

21. Implementation of these proposed changes will require an amendment to the PCIF for the introduction of differentiation of maturity and grace by income category, limiting maturity to certain categories of UMICs. Amendments to the PCIF are within the purview of the Governing Council so that these new financing conditions will come into effect once the changes to the PCIF have been submitted for approval to the Council in February 2022.

22. The changes in maturity premium differentiation based on income category are part of the revision of IFAD's methodology to determine the ordinary term interest rates applicable to borrowers and should be approved by the Executive Board.

23. In the interest of consistency and to provide borrowers with additional options, these changes should take place at the start of IFAD12 **without retroactive effect**. Financing already approved will continue to follow established contractual terms and pricing, including for intermediate term loans.

# VI. Conclusion and way forward

24. Mutually sustainable development financing requires differentiated financing conditions reflecting the different development stages of borrowers while ensuring systematic recovery of the cost of funding. IFAD has already differentiated financing conditions in place, but changes are required to reflect the financial transformation envisaged in IFAD12 including agreement by Members as to the graduation pillars.

25. IFAD's financial transformation allows the Fund to enhance the development impact for LICs and LMICs, while ensuring the capacity of these borrowers to absorb additional volume of debt. At the same time, it consents engagement with countries at a more advanced stage of development on terms that remain competitive compared to market financing options (e.g. bond issuance). In this way, IFAD will be able to serve the broad spectrum of its Members in a tailored approach consistent with their economic trajectory and debt, with the goal of helping all its borrowers achieve the Sustainable Development Goals and the 2030 Agenda.

26. This document is presented for discussion at the Audit Committee and Executive Board in April 2021, following initial discussions in two informal seminars in October 2020 and January 2021. Any related changes to the PCIF will be submitted for approval to the Governing Council in February 2022.

[6] Policies and Criteria for IFAD Financing, paragraph 4.

# Current premium maturity differentiation per income category

1. Effective from 2019, IFAD introduced premium differentiation for borrowers eligible for ordinary term loans, according to the country's per capita income or classification, based on IBRD principles of classification and pricing. Consequently, a borrower may be eligible for an exemption or discount, or subject to a surcharge.

2. The analysis of the current premium differentiation by income category shows that:

   (i) **Exemptions (category A)**. Member States falling into the following country classifications are exempt from the maturity premium increase applicable from the date of the 2019 Governing Council session: (i) borrowers transitioning from blend terms to ordinary terms during the replenishment period in which they transition and the next replenishment period; (ii) fragile and conflict-affected states; (iii) small state economies that are eligible for IBRD borrowing; and (iv) during IFAD11, Member States that became eligible for ordinary terms in IFAD9 or IFAD10, as well as Gaza and the West Bank.[7]

   (ii) **Discounts (category B)**. Countries with a GNIpc less than or equal to US$6,975[8] are eligible for a discount on the maturity premium increase.

   (iii) **Standard (category C)**. Countries with a GNIpc above US$6,975 and less than US$12,375 and not eligible for category A or B.

   (iv) **Surcharge (category D)**. Countries with a GNIpc greater than US$12,375[9] are subject to a surcharge on the maturity premium unless they are eligible for an exemption as described above.

[7] This includes Angola, Armenia, Plurinational State of Bolivia, Bosnia and Herzegovina, Dominica, Georgia, India, Philippines, Saint Vincent and the Grenadines, Sri Lanka and Viet Nam.
[8] This is the level of GNIpc (for FY20) that the World Bank has established as the start of the graduation discussion with IBRD borrowers. It is revised annually and published in the Per Capita Income Guidelines for Operational Purposes.
[9] This is the level of GNIpc (for FY20) that the World Bank has established as the high-income country cut-off. It is revised annually and published in the Per Capita Income Guidelines for Operational Purposes.

# Analysis of comparable financial products at other international financial institutions

Table 1
**Comparison of maturity, grace periods and average maturity periods at different international financial institutions**

| *Financing terms* | *IBRD* | *IFAD* | *Asian Development Bank* | *African Development Bank* | *Asian Infrastructure Investment Bank* | *Caribbean Development Bank* | *Inter-American Development Bank* |
|---|---|---|---|---|---|---|---|
| **Maximum maturity period (years)** | **35** | **35** | **30** | **25** | **35** | Countries with GDP per capita below US$2,000: **30**<br>Countries with GDP per capita between US$2,001 and US$10,000: **25**<br>Countries with GDP per capita above US$10,000: **20** | **25** |
| **Maximum grace period (years)** | **10** | **10** | **8** | **8** | **10** | Countries with GDP per capita below US$2,000: **10**<br>Countries with GDP per capita between US$2,001 and US$10,000: **5**<br>Countries with GDP per capita above US$10,000: **5** | **5** |
| **Maximum average maturity (years)** | **20** | **20** | **19** | **16.75** | **20** | Countries with GDP per capita below US$2,000: **20.25**<br>Countries with GDP per capita between US$2,001 and US$10,000: **15.25**<br>Countries with GDP per capita above US$10,000: **12.75** | **15.25** |