

Document: EB 2021/133/R.12
Agenda: 8(b)
Date: 9 August 2021
Distribution: Restricted
Original: English

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IFAD's ordinary term loans: Update of elements of pricing

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Executive Board – 133rd Session
Rome, 13-16 September 2021

For: Review

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Abbreviations and acronyms

GDI	Graduation Discussion Income
GNIpc	gross national income per capita
IBRD	International Bank for Reconstruction and Development
IFAD11	Eleventh Replenishment of IFAD's Resources
IFI	international financial institution
LIC	low-income country
LMIC	lower-middle-income country
SDR	special drawing rights
UMIC	upper-middle-income country

Executive summary

1. IFAD's continued financial transformation allows it to meet the ambitions of its stakeholders, as reflected in the Report of the Consultation on the Eleventh Replenishment of IFAD's Resources (IFAD11) and the IFAD12 Consultation Report. This includes meeting the increased demand for its concessional financial offerings. Specifically, it aims to enhance the development impact for low-income countries (LICs) and lower-middle-income countries (LMICs), while ensuring the capacity of these borrowers to absorb additional volume of debt in a financially sustainable way. 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 using a tailored approach consistent with their individual economic trajectories and that facilitates their risk management and debt situation, with the goal of contributing to their achievement of the Sustainable Development Goals and the 2030 Agenda.
2. IFAD introduced differentiated financing conditions in 2019. Building on the second pillar of IFAD's Revised Approach to Graduation agreed during the IFAD12 Consultation and, at the same time, implementing the principles already approved by the Executive Board for related changes to financing conditions,¹ Management hereby proposes three changes to update selected elements of pricing of IFAD's ordinary term loans:
 - (a) **Update of IFAD's maturity premium differentiation** to reflect the approved revised income categories and to implement the second pillar of IFAD's Revised Approach to Graduation.
 - (b) **Suspension of fixed spread of ordinary term loans for the IFAD12 period** in order to mitigate IFAD's refinancing risks until IFAD builds more experience in its mobilization of funding resources with new investors.
 - (c) **Discontinuation of the offer of ordinary term loans denominated in special drawing rights (SDR)** to support adequate asset and liability management (as SDR is not a functional currency in financial markets) and minimize currency risk on IFAD's balance sheet.
3. The above proposals were formulated in consideration of two main concepts:
 - (a) **Differentiated financing conditions.** Financing conditions will continue to be differentiated according to countries' income levels so that upper-middle-income countries (UMICs) with a gross national income per capita (GNIPC) above the Graduation Discussion Income (GDI) threshold pay more than those below, while UMICs pay slightly more than LMICs in their access to ordinary term resources. The pricing will ensure IFAD's attractiveness compared with countries' market financing options.
 - (b) **Financial sustainability of IFAD.** The Fund should ensure that the average onlending price is higher than IFAD's average cost of borrowing. The above-mentioned changes do not impact negatively the financial sustainability of the Fund.
4. Management expects to maintain IFAD's current pricing² methodology for determining the reference interest rate in IFAD12, continuing to use the same spread structure to price its ordinary term loans as that of IBRD. The proposed changes will: (i) not involve a major change in business processes and approved governance arrangements; (ii) be implemented through a roll-out plan with dedicated internal and external communications; and (iii) maintain IFAD's

¹ EB 2021/132/R.10/Rev.1.

² Currently, IFAD mirrors the structure of pricing of loans on ordinary terms issued by the International Bank for Reconstruction and Development (IBRD).

attractiveness in terms of financing offerings vis-à-vis other peer institutions (see annex I) for countries of all income category groups. It should be noted that lower-income category countries can access spreads that are slightly lower than the current pricing for ordinary term countries, while higher-income countries will pay a little more; all countries will be able to restrict the price of borrowing notably by choosing shorter maturity offerings.

5. This document is presented to the Audit Committee and the Executive Board in September for initial review. Management will submit the final arrangements to the Executive Board for approval at its 134th session, prior to the start of the IFAD12 cycle, to become effective following related changes to legal provisions to be approved by the Governing Council in February 2022.

I. Background

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 Member States to propose further elements of differentiation in IFAD's financing conditions.
2. It was also agreed that these conditions, and the pricing to be applied for borrowed resources, will be directed at ensuring that IFAD is able to recover the costs of borrowing to maintain its own financial sustainability while remaining attractive compared with market financing options (e.g. bond issuance).
3. Following these discussions, the Executive Board recently approved the definition (composition) of the different categories of countries eligible for ordinary term loan financing and agreed that a further differentiation of maturity premium would be implemented by Management for the IFAD12 cycle, based on the principles agreed in April 2021.
4. Finally, financial markets are facing the upcoming transition of the London Interbank Offered Rate (LIBOR) to alternative reference rates. The uncertainty around future funding costs based on new reference rates (most likely the secured overnight financing rate [SOFR] for funding denominated in United States dollars) calls for special attention around future refinancing risk, particularly in IFAD's case where market-based funding is yet to be fully developed. Therefore, defining fixed spreads over the life of a loan presents increased challenges.
5. This document aims to address the challenges above and proposes three updates of elements of pricing of IFAD's ordinary term loans.

II. Proposed updates of elements of pricing for IFAD's ordinary term loans

6. The proposed changes will determine: (i) the adjustment of the maturity premium differentiation by income category, based on the pillars of the graduation discussion; (ii) the suspension of the fixed spread option for the IFAD12 period in order to reduce IFAD's refinancing risks; and (iii) the suspension of SDR loans.
7. The scope of this proposal covers the financing conditions of IFAD ordinary term loans for public sector financing.

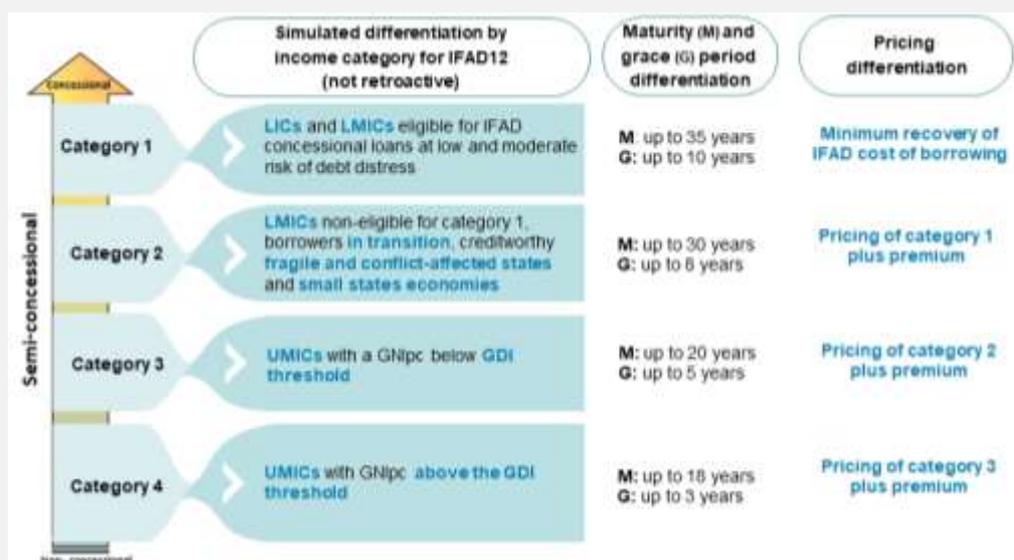
A. Adjustment of the maturity premium differentiation

8. 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; the length of the maturity of the loan; and strategic topics such as fragility of small states economies and countries in transition.
9. In April 2021, the Executive Board approved the amendment of the definition of the different categories of countries eligible by: (i) introducing a new category for countries initially eligible for IFAD's concessional resources; (ii) differentiating between the categories of LMICs and UMICs below GDI, which were previously considered as one category; and (iii) the removal of high-income countries as an eligible borrower category and substitution with the category of UMICs above GDI.

Box 1

In April 2021, the Executive Board approved a new categorization of IFAD's borrowers, effective from January 2022 ([EB 2021/132/R.10/Rev.1](#)).

- **Category 1** includes LICs and LMICs eligible for IFAD concessional loans, which can access IFAD semi-concessional loans from borrowed resources. This category will be subject to a maximum of 35 years' maturity and 10 years' grace period, with a maximum average repayment maturity of 20 years.
- **Category 2** includes LMICs non-eligible for category 1, borrowers transitioning, creditworthy conflict-affected states and small states economies irrespective of their GNlpc. This category will be subject to a maximum of 30 years' maturity and 8 years' grace period, with a maximum average repayment maturity of 18 years.
- **Category 3** includes UMIC borrowers with a GNlpc below GDI threshold that do not qualify for an exemption listed in category 2. This category will be subject to a maximum of 20 years' maturity and 5 years' grace period.
- **Category 4** includes UMICs with GNlpc above the GDI threshold that do not qualify for an exemption listed in category 2. This category will be subject to a maximum of 18 years' maturity and 3 years' grace period.



Differentiation of access to maturity and grace periods by income category applicable from IFAD12

10. Management's proposal effectively implements the agreed principles to adjust the maturity premium differentiation, in accordance with the recently approved categories of IFAD's borrowers that safeguards the principle that lower-income countries pay less than higher-income countries and benefit from higher levels of concessionality. UMICs above the GDI threshold will be subject to harder financial conditions relative to those UMICs below the threshold. UMICs below GDI will be subject to harder financial conditions relative to LMICs.
11. The proposed differentiation of maturity premium maintains the current structure based on income categories and the length of the maturity of the loan, shown in table 1. Specific examples of current pricing are given in box 2.

Table 1
Proposed maturity premium differentiation between categories

<i>New category / average maturity</i>	<i>8 years and below</i>	<i>Greater than 8 to 10 years</i>	<i>Greater than 10 to 12 years</i>	<i>Greater than 12 to 15 years</i>	<i>Greater than 15 to 18 years</i>	<i>Greater than 18 to 20 years</i>
Category 1: LICs and LMICs eligible for super highly concessional, highly concessional and blend terms. No high risk of debt distress.	0.00%	0.05%	0.15%	0.25%	0.35%	0.50%
Category 2: LMICs and UMICs eligible for ordinary terms and classified as fragile and conflict-affected states, small states economies or in transition	0.10%	0.20%	0.30%	0.40%	0.50%	N/A
Category 3: UMICs with a GNlpc below the GDI threshold	0.15%	0.25%	0.40%	0.50%	N/A	N/A
Category 4: UMICs with GNlpc above the GDI threshold and less than high-income countries' threshold or those considered eligible for official development assistance	0.25%	0.40%	0.60%	N/A	N/A	N/A

12. In view of IFAD's recent AA+ credit rating, it is important to highlight that the proposed changes to its maturity premium differentiation will allow IFAD's ordinary term financing to remain: (i) an attractive and sustainable source of external financing for the LICs and LMICs of category 1 by offering both a level of concessionality equal or above 50 per cent for the longest average maturity, and a spread that is for most average maturity buckets slightly lower than the current lowest category of pricing; and (ii) an attractive source of external financing vis-à-vis countries' market financing options for the other categories of countries, with a targeted level of concessionality at least higher than 20 per cent (ensuring semi-concessional levels). Other elements of pricing will remain unchanged.
13. Currently, the average maturity of IFAD's borrowing is approximately 10-12 years. The limited adjustment (5-10 basis points) between income categories for the loans with an average maturity between 8 years and below and up to 10-12 years represents an incentive for all categories, but in particular UMICs, to access resources with a shorter maturity and contribute to the financial sustainability of the Fund by promoting faster reflows. At the same time, it allows LICs and LMICs to access longer maturities with attractive pricing compared to other financing sources, including under the performance-based allocation system. It should be noted that countries will be able to restrict notably the overall pricing by choosing shorter maturity offerings.

Box 2

Differentiation of access to maturity and grace periods by income category applicable from IFAD12

- A country classified as an LMIC/LIC eligible for IFAD's core resources would have access to IFAD borrowed resources through the Borrowed Resource Access Mechanism. With the proposed changes, if this country borrowed for an average maturity of greater than 10 to 12 years (equivalent maturity period of 18 years and grace period of 3 years), the maturity premium applicable would be 0.15 per cent. The applicable maturity premium will be lower than the current maturity premium applicable to category A, which is 0.20 per cent.
- A country classified as an LMIC eligible for ordinary term loans and borrowing for an average maturity of greater than 10 to 12 years (equivalent maturity period of 18 years and grace period of 3 years) is currently subject to a maturity premium of 0.25 per cent. With the proposed changes, the maturity premium will be equal to 0.30 per cent. All the other elements of pricing remain unchanged. Therefore the increase in the loan pricing will be 5 basis points (bps).
- A country classified as a UMIC below GDI eligible for ordinary term loans and borrowing for an average maturity of greater than 10 to 12 years (equivalent maturity period of 18 years and grace period of 3 years) is currently subject to a maturity premium of 0.25 per cent. With the proposed changes, the maturity premium will be equal to 0.40 per cent. All the other elements of pricing remain unchanged. Therefore the increase of the loan pricing will be 15 bps.
- A country classified as a UMIC above GDI eligible for ordinary term loans and borrowing for an average maturity of greater than 10 to 12 years (equivalent maturity period of 18 years and grace period of 3 years) is currently subject to a maturity premium of 0.30 per cent. With the proposed changes, the maturity premium will be equal to 0.60 per cent. All the other elements of pricing remain unchanged. Therefore the increase of the loan pricing will be 30 bps.

B. Suspension of fixed spread in ordinary term loans

14. In 2019, IFAD introduced the option of a fixed spread for ordinary loans using different buckets of maturities as per the IBRD and updated the fixed spread, like IBRD, on a quarterly basis. IFAD's interest rate on ordinary term loans consists of a floating market reference rate (United States dollar - LIBOR 6-month, EURIBOR 6-month) plus a variable or fixed spread.
15. One essential element of the fixed spread is the projected funding cost. This is set upfront at the time of loan signing and does not change over the maturity of the loans.
16. During the IFAD11 cycle (from 2019 onwards), an envelope of US\$290.8 million of ordinary term loans was approved on fixed spread terms, representing 65 per cent of total ordinary term loans approved.
17. In April 2021, IBRD suspended the offer of loans on a fixed spread until further notice with the following exceptions: (i) the invitation to negotiate is issued on or before 26 January 2021; and (ii) the IBRD Executive Directors approve the loan on or before 30 June 2021.³
18. The reason for IBRD's suspension is linked to the upcoming transition from LIBOR to another reference rate, most likely SOFR. IBRD will start expressing their respective US\$ funding cost as a spread over SOFR instead of spread over US\$ LIBOR. However, currently, IBRD does not have sufficient experience using the new reference rate for its funding activities and cannot reliably project its funding cost over SOFR over the life of the loan. Therefore, until the funding experience enables the reliable projection of funding costs relative to the new alternative reference rate for IBRD's long-tenor loans, the fixed spread will remain suspended.
19. As IFAD uses similar elements of pricing as the IBRD, the Fund has applied the fixed spreads equal to IBRD's fixed spread as of October 2020, which are the latest available spreads for the determination of its reference rate on ordinary loans, up to and including the second quarter of financial year 2021 (FY 2021).
20. Considering the above, and in order to avoid further introduction of risk to IFAD's future financial sustainability (mispricing and refinancing risks), Management proposes the suspension of the offer and the determination of the fixed spread for ordinary term loans from 1 January 2022 (i.e. for IFAD12). To keep the flexibility to adapt to changes in due time, the suspension of the fixed spread will be re-evaluated by the end of IFAD12 (FY 2024). The option to re-introduce the fixed spread for ordinary loans after re-evaluation is connected to the developments of (i) the SOFR market, and (ii) IFAD's own pricing methodology.
21. The proposed measures would allow all projects in the pipeline for the remainder of 2021 to have the fixed spread option, with the spread being the last available IBRD one as at October 2020. At this stage, the pipeline of projects to be funded in ordinary term loans and to be approved at upcoming sessions of the Executive Board in 2021 amount to US\$172 million. As of today, the loans at an advanced stage of negotiations, demanding to borrow using a fixed spread, amount to US\$43 million (25 per cent).

C. Discontinuation of offer of ordinary terms loans denominated in special drawing rights

22. Since the introduction in August 2016 of single currency offer in United States dollar and euro loans as an alternative to SDR, a total envelope of US\$1.2 billion has been approved on ordinary term loans. Out of this envelope, only US\$14.2 million equivalent (representing 1 per cent in demand from one borrower only) was provided in a loan denominated in SDR. The rest were provided with a

³ Financial year closing date.

prominent demand for United States dollars (68 per cent) versus euro (31 per cent). This trend reflects the borrowers' preferences to manage their ordinary term loans in hard currencies, which facilitates their asset management from a currency composition point of view. This practice is confirmed at other international financial institutions (IFIs) and multilateral development banks (MDBs), as none of them offer the equivalent ordinary term loans in SDR denomination (see annex I).

23. IFAD's ordinary loans will increasingly be financed through borrowing, either in the form of bilateral loans or – with the implementation of the Integrated Borrowing Framework – through private bond placements that IFAD will be issuing to private institutional impact investors. As the SDR is not a functional currency in financial markets, borrowing liabilities will continue to be denominated in United States dollars and euro. Therefore, also from an asset and liability management perspective, it is strongly advisable to limit the denomination of ordinary loans to United States dollars and euro, so as to minimize currency risk on IFAD's balance sheet. As a second-order effect, having an increased share of outstanding loan assets denominated in United States dollars will also reduce foreign exchange fluctuations (i.e. unrealized accounting gains or losses) on IFAD's financial statements, which are expressed in United States dollars.
24. Considering all the elements above, Management proposes the discontinuation, from 1 January 2022, of the offer of ordinary term loans denominated in SDR. This is not expected to have any impact on demand for IFAD loans, given the above experience. The offer of denomination in SDR will remain available for the concessional loans on super highly concessional, highly concessional and blend terms.

III. Implementation

25. The implementation of the proposed changes will not introduce a change in the approved arrangements for determining IFAD's reference rate. While the President of IFAD⁴ is authorized to establish the IFAD rate of interest routinely, without prior Board approval, the Executive Board is notified of the interest rate so established.
26. No significant changes in internal systems or additional staff capacity are anticipated, and risks for IFAD will be further mitigated, as explained in the relevant sections above.
27. The proposed changes will be implemented through a roll-out package including internal and external communications, and capacity-building for staff and stakeholders to manage different borrower options and integrate more complex risk management and asset liability management. The proposed changes to financing terms will be integrated into the current transparency action plan in line with Management's commitments. This will allow additional information on financing terms and rates, and product notes to be made available by the start of 2022.

IV. Conclusion

28. This set of proposals forms part of IFAD's transformative package of enhanced responsiveness and is in line with the principles already agreed with Members during the IFAD12 Consultation – also in terms of enhanced risk management. While recognizing that there may be trade-offs for individual countries, the proposals focus on continuing to provide a broad package of options and value for all stakeholders.

⁴ Decisions of the Executive Board at its ninety-seventh session in September 2009 (EB 2009/97/R.46/Rev.2) and 125th session in December 2018 (EB 2018/125/R.45/Rev.1)

29. This document is presented for review by the Audit Committee and Executive Board in September 2021. Feedback will be incorporated into a revised document to be submitted for approval to the Executive Board in December 2021.

Comparison of elements of financing terms with other IFIs/MDBs

IFI name	IFAD	IBRD	Asian Development Bank	African Development Bank	Inter-American Development Bank	Asian Infrastructure Investment Bank	Caribbean Development Bank
Credit rating	AA+	AAA	AAA	AAA	AAA	AAA	AA+
Facility	IFAD12 ordinary loan (proposed)	IBRD flexible loan	LIBOR-based loan	Fully flexible loan	Flexible Financing Facility - investment loan	Sovereign-backed loan	Ordinary capital resources loan
Maturity	Up to 35 years by category	35	30	25	25	35	n.a.
Grace period	Up to 10 years by category	10	8	8	5 (6 months after original disbursement period)	10	5
Max average maturity	Up to 20 years by category	20	19	17	15.25	20	Up to 17 or 22 years by country group
Front-end fee (%)	n.a	0.25	0	0.25	0	0.25	0
Commitment fee (%)	n.a	0.25	0.15	0.25	0.5	0.25	1
Fixed spread offer	To be suspended	Suspended	No	Suspended	No	Suspended	No
Variable spread offer	Yes	Yes	Yes	Yes	Yes	Yes	Yes
SDR loan offer	To be discontinued	Not available	Not available	Not available	Not available	Not available	Not available