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Update of IFAD's ordinary loans pricing

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Useful references: Proposed Amendments to the Policies and Criteria for IFAD Financing and Adoption of the Framework on Financing Conditions (EB 2021/134/R.19); IFAD Graduation Policy (EB 2021/133/R.5); IFAD Asset and Liability Management Framework (EB 2019/128/R.46); IFAD's Integrated Borrowing Framework (EB 2020/131(R)/R.21/Rev.1); Borrowed Resource Access Mechanism: Framework for Eligibility and Access to Resources (PBAS 2021/15/W.P.3)

Action: The Executive Board is invited to approve the proposal for the update of IFAD's pricing for ordinary loans as presented in this document.

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Update of IFAD's ordinary loans pricing

I. Background

1. IFAD's ordinary loans are priced based on a market reference rate and a variable spread. The market reference rate is the Secured Overnight Financing Rate (SOFR) for loans denominated in United States dollars and the six-month Euro Interbank Offered Rate (EURIBOR) for euro-denominated loans.[1] The spread applied by IFAD is based on the funding spread used by the International Bank for Reconstruction and Development (IBRD),[2] which is updated quarterly.

2. The elements of IFAD's variable spread are: (i) IBRD's average actual funding spread; (ii) IBRD's contractual spread; and (iii) IFAD's maturity premium by country category.

3. Until December 2021, IFAD applied all elements of IBRD's variable spread. Starting from 1 January 2022, IFAD introduced its own maturity premium differentiation and country categories to reflect the principles of IFAD's Graduation Policy.[3,4]

4. However, IFAD continued to apply the IBRD funding spread over the market reference rates. This funding spread is representative of IBRD's cost of borrowing on the markets, and like all other international financial institutions (IFIs), with no exception, IBRD applies a funding cost-pass-through (FCPT) mechanism to pass on the cost of funding to borrowers when pricing the loans.

5. IFAD is the only IFI that does not pass on the cost of funding to borrowers by applying a FCPT mechanism to loan pricing. While replenishment contributions will remain the bedrock of IFAD's financing, borrowing has become a more prominent part of IFAD's resource structure and will fund an increasing share of ordinary loans on the balance sheet.

II. Rationale for the proposal

6. The proposal is to maintain the existing methodology to price IFAD's ordinary loans. No change in the elements is proposed, as they are aligned with the market standard and are appropriate and logical for the type of activity concerned and the nature of an IFI.

7. The key proposed change is to apply the methodology in a more financially sound manner, by introducing IFAD's own FCPT mechanism based on its actual funding spread for the United States dollar and the euro.[5] The other elements of the spread (contractual spread and maturity premium) will stay at their current level, with the proposal to introduce a defined window ahead of each replenishment cycle for potential revision of such elements, thereby fully delinking the elements from IBRD.

8. The proposal is based on the recognition of significant changes in IFAD's financial reality having occurred in recent years and the need to ensure continued financial sustainability within this reality. The changes refer to: first, the increased sophistication of IFAD's financial hybrid structure and resource structure; second, the increased reliance on borrowed resources, which became a larger share of IFAD's resource structure; and third, an enhanced risk management framework and

[1] Ordinary loans denominated in special drawing rights (SDRs) have not been offered since January 2022. For existing SDR-denominated loans, IFAD applies an SDR-weighted average of SOFR, EURIBOR, Shanghai Interbank Offered Rate (SHIBOR), Tokyo Overnight Average Rate (TONAR) and Sterling Overnight Index Average (SONIA).
[2] IBRD variable spreads.
[3] EB 2021/133/R.5.
[4] Two other updates introduced in January 2022 were the suspension of ordinary loans with fixed spread and the discontinuation of ordinary loans denominated in SDRs: EB 2021/134/R.19.
[5] For SDR-denominated ordinary loans, IFAD will apply its funding costs for United States dollars and euros in proportion to their weight in the SDR basket.

Asset and Liability Management (ALM) Framework[6] that require IFAD, as a rated entity, to pay particular attention to its financial policies and remain aligned with best practices of other IFIs.

9. The practice of applying the IBRD funding spread to IFAD's ordinary loans did not present significant financial risks as long as IFAD was funded purely by replenishment contributions. However, IFAD started borrowing in 2014 and has now tapped into financial markets by issuing private placement bonds. As at 30 June 2022, borrowing in a form other than concessional partner loans stood at US$1.4 billion, on which IFAD is paying interest representative of its own funding cost. In the future, IFAD will continue to fund ordinary loans through borrowed resources.[7]

10. IBRD is a AAA rated institution and one of the most well-established issuers in the market. It has issued between US$40 billion and US$75 billion[8] worth of bonds annually in the past three fiscal years, both in public benchmarks and in private placements. Due to the rating difference between IFAD (AA+) and IBRD, and since IFAD is not issuing large public benchmark bonds, IFAD's funding spread will naturally remain higher than that of IBRD. The differential can be expected to average between 15 bps and 25 bps, depending on the markets and currency, and is expected to improve as IFAD becomes a more seasoned issuer.

11. IFAD is the only IFI that does not apply a FCPT mechanism, which is a pillar of the pricing policies of all IFIs. The risk of a financial loss associated with not using a formula-based FCPT mechanism to pass IFAD's actual funding cost onto borrowers will continue to increase as IFAD relies more on borrowing.

12. Using IBRD's funding spread means de facto that the difference between IFAD's actual funding costs and IBRD's funding cost is indirectly absorbed by IFAD, eroding IFAD's net interest margin and capital, and in turn reducing IFAD's core resources available to countries most in need. Furthermore, as IFAD engages more and more with external stakeholders such as rating agencies and investors, not having its own FCPT could raise concerns.

13. In line with the FCPT methodology, any improvement in IFAD's funding spread will also be passed on to borrowers. The correct application of an FCPT methodology is a necessary and natural step in line with IFAD's increased financial sophistication and the need for financial sustainability.

14. With this proposal, IFAD's pricing will continue to respect its core principle of universality and the principles of the Graduation Policy, as well as a different concessionality level among country categories.[9] The increase in the spread resulting from the application of IFAD's funding spread will be shared among all borrowers with ordinary loans, in line with IFAD's cooperative nature.

15. The IFAD offer package will continue to be significantly more concessional than market funding for most of the borrowers that issue bonds, not only due to the interest rate but also in consideration of the very long maturities and grace periods offered, which are not available on the market or even from other IFIs. When compared to other IFIs, it should also be recalled that IFAD will continue not to apply front-end and commitment fees.[10]

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[6] EB 2019/128/R.46.
[7] As at 31 December 2022, IFAD's outstanding ordinary loans were approximately US$955 million equivalent.
[8] IBRD financial statement June 2022; IBRD financial statement June 2021.
[9] IFAD's maturity premium grid differentiates among four country categories: C1: low-income countries and lower-middle-income countries (LMICs) eligible for IFAD's concessional loans and at low and moderate risk of debt distress; C2: LMICs not eligible for category 1, borrowers transitioning, creditworthy conflict-affected states and small states economies irrespective of their gross national income per capita (GNIpc); C3: upper-middle-income country (UMIC) borrowers with a GNIpc below Graduation Discussion Income (GDI) threshold that do not qualify for an exemption listed in category 2; C4: UMICs with GNIpc above the GDI threshold that do not qualify for an exemption listed in category 2.
[10] These would translate into approximately an additional 12 bps, if applied.

III. Details of the proposal

A. Overarching principles of IFAD's pricing

16. The revised proposal is based on the following principles:

(i) **Financial sustainability of borrowed resources.** In line with IFAD's Integrated Borrowing Framework,[11] the average cost of borrowing (or funding cost) should be lower than the average onlending spread. Furthermore, IFAD's pricing will be adjusted when needed to preserve overall financial sustainability.

(ii) **Simplicity and stability.** IFAD's pricing methodology should continue to be simple in its elements and stable over time. Of the individual elements of the spread, only IFAD's funding cost is to be updated every quarter.

(iii) **Equal treatment of borrowers across the rating scale.** For the calculation of loan pricing, there should be no differentiation among single counterparty's sovereign ratings as this would run counter to IFAD's development mandate and preferred creditor status.

(iv) **Competitiveness with peers.** The final IFAD offer should be competitive with the offer of its peers. This accounts for other elements beyond the spread including the maturity and grace period, and the commitment and up-front fees. Borrowers should still be willing and able to take IFAD's loans after taking into account the available funding for IFAD's specific focus, comparative advantage and expertise in the most remote rural areas.

17. The proposal was reviewed by external stakeholders, including peer institutions. The review evidenced how this proposal closely follows the methodology of other IFIs in terms of the elements and basic nature of these elements (please see the annex). The review process highlighted the importance of keeping the pricing methodology simple. This is fully in line with IFAD's overarching pricing principles stated above.

B. Elements and methodology

18. The IFAD ordinary loan interest rate will continue to have two key elements as is the case at the moment: a market reference rate and an IFAD spread. The technical details of each element are described below.

IFAD interest rate = Market reference rate + IFAD spread

19. **Market reference rate** will remain as is, i.e. (i) SOFR for loans denominated in United States dollars; and (ii) six-month EURIBOR for loans denominated in euros.

20. **IFAD spread** will comprise: (i) IFAD's average funding cost; (ii) IFAD's maturity premium; and (iii) IFAD's contractual spread:

IFAD spread = IFAD avg. funding cost + IFAD maturity premium + IFAD contractual spread

- **IFAD's average funding spread.** This is calculated based on the actual average spread for borrowing in each respective currency. The average funding spread in United States dollars and euros will be calculated by including all related costs incurred by IFAD to source the funds in the

[11] EB 2020/131(R)/R.21/Rev.1.

respective currency, inclusive of hedging costs.[12,13] The spread will be updated quarterly at the beginning of the quarter (in line with the current IBRD practice).

- **IFAD maturity premium**. The IFAD maturity premium grid, introduced in January 2022[14] as a result of approval of the Graduation Policy and Borrowed Resource Access Mechanism (BRAM),[15] will remain unchanged. The maturity premium reflects both the premium for loans with longer average repayment maturity and the price differentiation between countries in different categories (C1 to C4). Table 1 shows the IFAD maturity premium grid introduced in January 2022.

  It is proposed that the maturity premium grid be updated once every three years, in the last year of a replenishment cycle for the following replenishment cycle, in order to keep stability and predictability of pricing for borrowers. This will give IFAD a window to account for potential mismatches between the average maturities of assets and liabilities.

Table 1
IFAD's maturity premium grid from January 2022

	8 years or less	*8 to 10 years*	*10 to 12 years*	*12 to 15 years*	*15 to 18 years*	*18 to 20 years*
C1	0.00%	0.05%	0.15%	0.25%	0.35%	0.50%
C2	0.10%	0.20%	0.30%	0.40%	0.50%	
C3	0.15%	0.25%	0.40%	0.50%		
C4	0.25%	0.40%	0.60%			

- **IFAD contractual (lending) spread**. The contractual spread is intended to absorb expected credit losses from the ordinary loan portfolio and provide a lending margin to enable IFAD to lend to all of its borrowers, including low-income countries. At the same time, the contractual spread serves to stabilize IFAD's overall capitalization and financial sustainability. For the Twelfth Replenishment of IFAD's Resources (IFAD12), the contractual spread will stay at the same level as the current IBRD contractual spread (50 bps).

  It is proposed that the contractual spread is updated once every three years, in the last year of a replenishment cycle, for the following replenishment cycle. This will maintain the stability and predictability of pricing for borrowers and preserve IFAD's overall financial sustainability. The initial assessment for IFAD13 indicates a level of contractual spread in the range of 50 bps to 60 bps. This is aligned with the purpose of the contractual spread in all other IFIs. Beyond IFAD13, this contractual spread will depend on the projected evolution of the overall lending portfolio mix (including the level of concessionality). Table 2 summarizes the proposed changes from the current pricing.

[12] IFAD may need to enter into derivative transactions for hedging purposes to align the funding with the assets to be funded, in line with the ALM Framework.
[13] IFAD's average funding spread was approximately 35 bps to 40 bps for euros and 70 bps to 75 bps for United States dollars in 2022. For SDR-denominated loans, IFAD will apply a weighted average of its funding spreads in the respective currencies.
[14] EB 2021/134/R.19.
[15] PBAS 2021/15/W.P.3.

Table 2
Summary of proposed changes

	Existing	*Proposed*
Funding spread	IBRD's cost of funding	Introduction of IFAD's cost of funding based on the actual spreads for each currency (US$/EUR) and including hedging costs.
Maturity premium	IFAD's maturity premium matrix implemented since 1 Jan 2022	Unchanged. Introductions of update frequency, every replenishment.
Contractual/lending spread	IBRD contractual spread of 50 bps	IFAD contractual spread of 50 bps. Introductions of update frequency, every replenishment.

C. Applicability

21. The updated pricing element will be applied to the entire stock of ordinary loans and all new ordinary loans after Executive Board approval. This is the key feature of the FCPT methodology, as IFAD is already bearing the funding cost to finance the existing stock of loans, and needs to pass on such cost to the borrowers.

22. The other pricing elements for existing loans will stay at their current level: the proposal is to maintain the IFAD contractual spread at the same level as currently used; the maturity premium is fixed at the time of loan approval and does not change throughout the loan life.

23. IFAD's existing financing agreements will not have to be amended as they refer generically to the Fund's General Conditions for Agricultural Development Financing and indicate the terms at which the loan is granted. The General Conditions in turn refer to the IFAD reference interest rate, which is defined as the rate determined periodically by the Fund as its reference rate for the computation of interest on its loans.

24. The General Conditions further specify that "Loans provided by the Fund shall be extended on the terms specified in the Financing Agreement and determined in accordance with the applicable lending policies of the Fund". Therefore, upon approval of the present document, IFAD's funding cost may be applied as a component of the IFAD reference interest rate starting from the calendar quarter that immediately follows such approval.[16]

25. IFAD will continue to publish the applicable rates on its website every quarter.

IV. Governance

26. The authority to approve the loan pricing elements and changes thereto resides with the Executive Board.

27. The Financial Operations Department will continue to be responsible for calculating and updating the ordinary loan pricing, including IFAD's funding spreads.

28. The regular review of the maturity premium and the contractual spread will be undertaken every three years and will serve as an input for financial projections of the new replenishment cycle.

V. Communication with borrowing countries

29. As is the case with the SOFR, IFAD will develop a communication plan and the relevant knowledge management tools to support smooth communication and implementation with borrowers.

[16] Pursuant to section 5.01(c) of the General Conditions for Agricultural Development Financing, IFAD publishes the IFAD reference interest rates applicable to its loans on a quarterly basis.

Pricing methodology for comparable products of other international financial institutions

International Bank for Reconstruction and Development (IBRD)

Product	*Pricing elements*		
	Final interest rate simplified formula	*Reference rate*	*Specific elements of spread*
IBRD flexible loan	Interest rate = base rate + variable spread [a]	SOFR, 6-month – EURIBOR	**Variable spread** consists of: Average funding costs + maturity premium + contractual spread **Maturity premium:** Based on country grouping (group A – D) and maturity bucket (average maturity of the loan from 8 years and below up to 20 years). Premium range is 0 bps to 115 bps.

[a] Fixed spread is suspended as of 1 April 2021.

Inter-American Development Bank (IDB)

Product	*Pricing elements*		
	Final interest rate simplified formula	*Reference rate*	*Specific elements of spread*
Flexible financing facility	Interest rate = base rate + variable spread	SOFR	**Variable spread** consists of: Funding margin + variable lending spread **Maturity premium:** Maturity premium is part of the variable lending spread and it is not presented separately

African Development Bank (AfDB)

Product	*Pricing elements*		
	Final interest rate simplified formula	*Reference rate*	*Specific elements of spread*
Fully flexible loan	Interest rate = base rate + variable spread	SOFR, 6-month – EURIBOR	**Variable spread** consists of: Funding cost margin + maturity premium + lending margin **Maturity premium:** Based on the average maturity (below 12.75 years; 12.75 to 15.0 years; more than 15 years). Premium range is 0 bps to 20 bps.

Asian Development Bank (ADB)

Product	*Pricing elements*		
	Final interest rate simplified formula	*Reference rate*	*Specific elements of spread*
Regular ordinary capital resources	Interest rate = base rate + interest spread	SOFR, 6-month – EURIBOR	**Interest spread** consist of: Funding cost margin + maturity premium + effective contractual spread **Maturity premium:** Based on country grouping (B, C0 – C4) and maturity bucket (average maturity of the loan from 9 years and below up to 19 years). Premium range is between 0 bps and 75 bps.

Asian Infrastructure Investment Bank (AIIB)

Product	*Pricing elements*		
	Final interest rate simplified formula	*Reference rate*	*Specific elements of spread*
Sovereign-backed loan, variable spread loan	Interest rate = base rate + variable interest spread [a]	SOFR, 6-month – EURIBOR	**Variable spread** consists of: Borrowing cost margin + contractual lending spread + maturity premium **Maturity premium:** Based on average maturity of the loan between 8 years and below up to 20 years. Premium range is between 0 bps and 75 bps.

[a] Fixed spread is suspended as of 15 April 2021.