IFAD
Investing in rural people

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Option of fixing the variable market reference rate for variable rate loans

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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:

1) Approve the proposal of an option to fix the market reference rate for variable rate loans denominated in United States dollars and euros as presented in this document.
2) Approve the proposed amendment to the Framework on IFAD Financing Conditions presented in annex I of this document. The changes to the document are reflected as follows: deleted text with strikethrough, added text underlined.

Technical questions:

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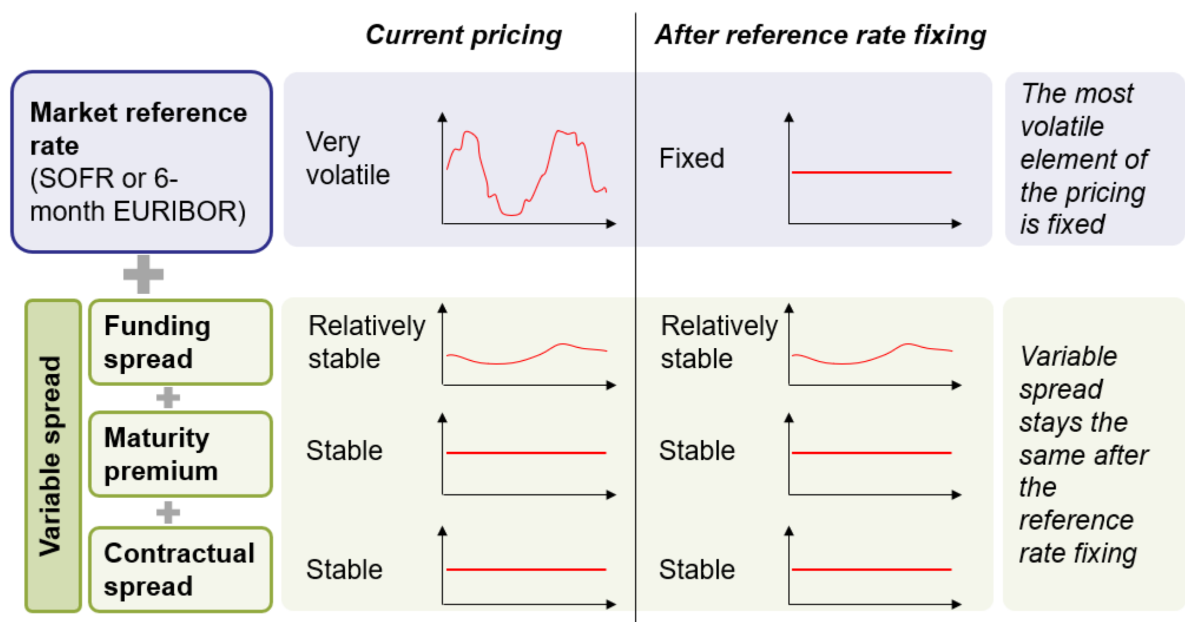
Option of fixing the variable market reference rate for variable rate loans

I. Background

1. **Certain IFAD borrowers have loans with variable interest rates and are therefore exposed to the risk of volatile interest payments.** The interest rate for variable rate loans is composed of a variable market reference rate (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) and a spread. The market reference rate is the most volatile element of the total interest rate. This means that the amount of interest due from borrowers with variable rate loans fluctuates each interest payment period depending on market conditions. This is relevant both for the sovereign borrowing portfolio (ordinary loans) and for the private sector portfolio. For simplicity, the rest of the document will focus on ordinary loans in the sovereign portfolio. However, the same logic and technical aspects would apply to variable rate loans in the private sector portfolio.

2. **Fixing a loan's variable market reference rate improves the predictability of the future borrower's interest payments**. Ordinary loans have a long maturity (from 18 to 35 years depending on the country category).[1] During this period, which can span multiple economic and interest rate cycles, variable market reference rates can change significantly based on several factors evaluated by central banks and the pattern is hard to predict (scheme 1 below). Fixing the market reference rate would mean fixing the most volatile element of the total interest rate payment. For many borrowers, the predictability of their future debt service obligations is particularly important as it can enable them to avoid shocks to their public finances.

Scheme 1
Illustration of the reference rate fixing for the ordinary loan



[1] Framework on IFAD Financing Conditions.

3. **The other elements of the total interest rate would remain unchanged and are rather stable.** The other elements are the funding spread (variable every quarter), the contractual spread (fixed) and the maturity premium (fixed). Following the implementation of IFAD's funding cost-pass-through[2] on 1 January 2025, the variations in the funding spread are expected to be very small (up to a few basis points quarter-over-quarter).

4. **Fixing the market reference rate does not guarantee to the borrower a lower amount of interest overall or at any point during the lifecycle of the loan.** Depending on market circumstances, including the level at which the reference rate of the loan is fixed and the level of future market reference rates, the borrower could end up paying a higher or lower cumulative interest amount after the fixing of the market reference rate. This will only be known at the end of the loan lifecycle. The fixing option should be used and considered primarily as a risk mitigation tool to limit the fluctuation of future interest payments, and not as an interest payment saving tool.

5. **At the moment of fixing, the concessionality of the loan will be the same as before the fixing.** The fixed rate represents the expected evolution of the variable market reference rate over the remaining life of the loan. Therefore, at the moment of fixing, the two rates are financially equivalent.

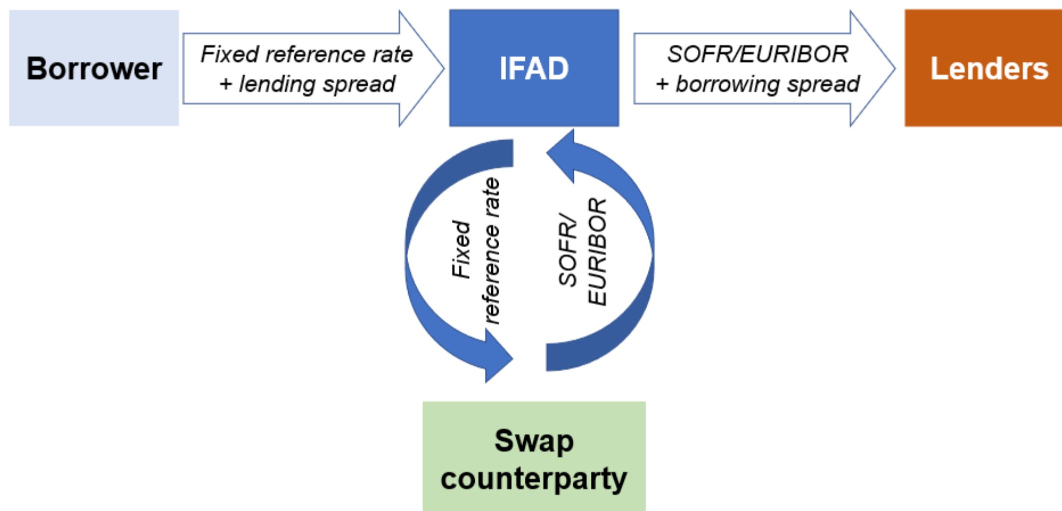
6. **Fixing of the variable market reference rate will not increase interest rate risk for IFAD.** Currently, IFAD mitigates interest rate risk by applying the same market reference rate to ordinary loans and to the borrowing that finances those ordinary loans. In the case of reference rate fixing, IFAD would hedge itself by entering into a back-to-back interest rate swap (IRS) with a market counterparty. The net effect of this IRS would be that IFAD would again receive a variable rate, which would match its borrowings. Scheme 2 below illustrates the cashflows.

[2] EB 2023/138/R.7.

Scheme 2
Illustration of cash flows

a) *Before the reference rate fixing*

b) *After the interest rate fixing*



7. **The implementation of the market reference rate fixing is expected in 2025, conditional on full operational readiness.** This includes creating, amending and approving all underlying legal documentation and adjusting the billing system (FlexCube).

II. Rationale for the proposal

8. **This proposal is part of IFAD's wider effort to expand the products and services available to its borrowers.** This is being undertaken in the context of financial reform aimed at maintaining financial sustainability and managing financial risks prudently. Strategic documents produced during the Consultation on the Thirteenth Replenishment of IFAD's Resources (IFAD13), such as IFAD13 Directions[3] and IFAD13 Report,[4] also support further financial innovations and alignment of IFAD's offer with other international financial institutions (IFIs). Providing an option to fix the variable market reference rate for outstanding ordinary loans denominated in United States dollars and euros could help borrowers manage their future expenditure projections.

9. **Fixing the variable market reference rate offers advantages for both borrowers and IFAD:**

   (a) The main advantage for borrowers is the ability to mitigate the risk linked to future increases in the interest rate and to gain predictability over future expenses for better budgeting. The product is not a guarantee that the borrower will pay lower interest, but rather that the future interest payments will be much more stable.

[3] IFAD13/1/R.6/Rev.1.
[4] GC 47/L.5.

(b) For borrowers without access to market tools to fix the rate, IFAD's reference rate fixing service would provide a unique debt management tool to mitigate their exposure to the risk of interest rate increase.

(c) For borrowers with access to the market tools, having IFAD as a counterparty instead of a commercial bank would present three main advantages: (i) reference rate fixing with IFAD would be administratively simpler as IFAD would not require the borrower to sign an International Swaps and Derivatives Association (ISDA) agreement[5] nor to post collateral, which a commercial bank would certainly do; (ii) given that IFAD has a better credit rating than all major banks, the borrower would take on very low counterparty credit risk; (iii) IFAD would leverage its AA+ rating and obtain lower swap fees compared to what the borrower would get, thereby effectively lowering the total cost for the borrower.

(d) IFAD would also indirectly benefit from borrowers having better public debt management. More sustainable public finances on the part of the borrowers would reduce the risk of their default in the long run, especially in the case of sizable loans.

10. **All major IFIs offer a similar treasury service**. The team has analysed the services offered by four major peers: the International Bank for Reconstruction and Development (IBRD), the African Development Bank (AfDB), the Asian Development Bank (ADB) and the Inter-American Development Bank (IDB). There is a high level of similarity in terms of the offer and the main fixing parameters among peers, with some nuances. IFAD's proposal for reference rate fixing presented in this document is aligned with those of its peers. By introducing this treasury product, IFAD will come one step closer to the best practices of other IFIs. (Annex II provides more detail on the peer analysis.)

III. Details of the proposal

A. Proposed parameters for market reference rate fixing

11. **Fixing will be an additional option available to borrowers, not an obligation.** It will be fully demand-driven and based on the borrower's written request for fixing. The borrower will not be obliged to make use of it, nor will it have to declare at loan signing whether or not it intends to. All terms of the fixing, the benefits and the risks will be clearly communicated to the borrowers before they proceed with the fixing option.

12. **There will be clear eligibility criteria.** The initial criteria that will be reflected in the reference rate fixing guidelines approved by Management are reported here below. After the initial phase of implementation, Management will approve any change to these criteria that are required.

(a) **Eligible loans:** ordinary loans (or variable rate loans for the private sector) that have reached at least 50 per cent disbursement. The minimum amount for the fixing is the full 50 per cent disbursed amount.[6] This means that each loan will have a maximum of two reference rate fixings per loan. At a later stage, IFAD may consider lowering the minimum disbursement threshold for the first fixing.

(b) **Eligible borrowers:** borrowers who have outstanding ordinary term loans (or variable rate loans in the case of the private sector). In principle, high credit risk borrowers that are ineligible for the Borrowed Resource Access Mechanism (BRAM) will not be allowed to fix the reference rate. However, this

[5] An ISDA agreement is a standardized document outlining the general terms and conditions applicable to all swap transactions between the parties.
[6] In order to enter into an interest rate swap, future cashflows (repayments) of the loan need to be known and fixed. This is the case only for the disbursed portion of the loan.

option might still be granted on a case-by-case basis following consultations with all relevant divisions, and consideration of the specific circumstances of the borrower or the loan.

(c) **Eligible currency:** ordinary term loans denominated in United States dollars and euros. Reference rate fixing will not be available for loans denominated in special drawing rights (SDR), as there is no adequate market instrument to hedge the SDR reference rate.

(d) **Applicability:** outstanding ordinary loans approved in the past and all future ordinary loans. Initially, most of the eligible loans will be existing ordinary loans as these will have reached the disbursement threshold of at least 50 per cent.

(e) **Timing:** the borrower can request fixing at any point after the eligibility criteria are met. The borrower does not have to communicate their intention to fix the reference rate at an earlier stage (e.g. at the time of loan negotiations or loan signing).

(f) **Type of fixing:** the only element that will be fixed will be the variable market reference rate (SOFR or six-month EURIBOR). The spread will remain variable, although it is expected to be relatively stable.

(g) **Minimum amount:** the minimum amount for the first fixing is 50 per cent of the loan amount (already disbursed). The second fixing would cover the remaining amount once the loan is fully disbursed.

(h) **Process:** IFAD would proceed with the fixing following the receipt of a written legally binding request from the borrower.

(i) **Period of fixing:** until the loan's final legal maturity. Once the reference rate is fixed, there will be no option to unfix the rate before loan maturity. Borrowers will be encouraged to make the decision about fixing based on the long-term need for predictability of the interest payment and not based on short-term trends in interest rates. At a later stage, IFAD may consider introducing the option to unfix the reference rate.

(j) **Pricing:** the fixed reference rate obtained from the market will be passed through to the borrower, including all associated swap fees.

(k) **Fees:** IFAD will charge minimal fees to cover the service costs. This is in recognition of the fact that this additional option for borrowers requires engagement by multiple IFAD teams.

(l) **Loan prepayment:** if the borrower prepays the loan (in full or in part), the borrower would bear all swap unwinding costs (payment of swap termination costs). In reality, IFAD's borrowers have never prepaid their loans, so this eventuality is considered highly improbable.

(m) **Borrower default:** if a borrower defaults, IFAD would have the right to unwind the swap and pass on the swap unwinding costs to the borrower. Unwinding the swap would only be considered in cases where it is unlikely that the borrower will pay its arrears in the near future. In such circumstances, the loan would revert to a variable market reference rate. The likelihood of the borrower entering into arrears would be evaluated, as per current practice, among the relevant IFAD divisions.

B. Legal considerations

13. **The option for reference rate fixing will be included in IFAD's Framework on Financing Conditions**. Other IFAD documents, such as the General Conditions for Agricultural Development Financing and the Policies and Criteria for IFAD Financing (PCIF), would not need to be amended as they do not contain references to detailed financial conditions. The amendments to the Framework on Financing

Conditions are being submitted to the Executive Board together with this proposal (see annex I).

14. **IFAD will develop guidelines with detailed terms and conditions for reference rate fixing**. In addition to the above-mentioned eligibility criteria, the guidelines will contain a template/form that borrowers can use to apply for the fixing and will be made available on IFAD's website.

15. **The market reference rate fixing will be legally operationalized for individual loans through an exchange of letters between the borrower and IFAD.** The borrower would send a legally binding letter to IFAD requesting the reference rate fixing by giving IFAD a mandate for execution, indicating the maximum level of the fixed rate that the borrower is willing to accept and the timeframe for execution. Following the borrower's request and execution of the interest rate swap in the market, IFAD would send a letter to the borrower confirming the market reference rate fixing and the commercial terms at which the fixing took place. If IFAD is not able to execute the transaction in the market, the borrower's request for fixing will be denied.

16. **The financing agreement template will be adjusted to reflect the option of reference rate fixing.** This will be relevant only for new agreements, where financing agreements can be used as important communication tools with the borrowers. The existing financing agreements will not be amended, and the fixing will follow the process of the letter exchange explained above.

C. Operational considerations

17. **The process of the variable market reference rate fixing would follow the main steps below:**

Pre-fixing phase:

- The borrower sends a request for an indication of a fixed rate for a specific ordinary loan.
- IFAD provides an indicative fixed rate based on the market conditions.
- If the indicative rate is acceptable to the borrower, the borrower will submit a written fixing request.

Fixing phase:

- The borrower submits a written, legally-binding request to fix the reference rate using IFAD's standard template. The document will, among others, indicate the maximum acceptable fixing rate.
- If Treasury is able to achieve the rate indicated in the request, Treasury will lock in the rate in the market through a swap transaction and immediately communicate confirmation of the rate to the borrower.
- If Treasury is not able to achieve the rate indicated in the request before the request's expiry date, IFAD will send a formal notification to the borrower.

Post-fixing phase:

- The loan entry in the loan billing system (FlexCube) will be adjusted to reflect the reference rate fixing.

D. Risk management considerations

18. **Swap counterparty default risk.** If the swap counterparty fails to meet its contractual obligation, IFAD would not receive the variable reference rate under the swap agreement. This is the same risk that IFAD faces for all its swaps.

19. **Mitigation.** IFAD has established a minimum engagement credit rating[7] for all of its swap counterparties. This means that in practice the counterparty default risk is very low. In the case of a swap counterparty default, IFAD would enter into a new swap agreement with another counterparty for the remaining tenor of the loan. Also, these swaps will help to offset IFAD's exposure with the same swap counterparty on the borrowing side.

20. **Borrower default risk.** This risk would materialize if the borrower were to stop paying its interest and principal obligations. However, IFAD would still have to honour its commitments under the interest rate swap (paying a fixed rate, but receiving a variable one).

21. **Mitigation.** IFAD carefully manages its exposure with borrowers, especially where there are payment arrears. It has successfully exercised its preferred creditor status and has kept its non-performing loans at a very low level. On average, ordinary term borrowers have higher credit ratings than the rest of IFAD's loan portfolio. Also, reference rate fixing will not be offered to high-risk borrowers that are ineligible for the BRAM. Where the swap needs to be unwound due to a borrower's default, the swap mark-to-market and all termination costs would be charged to the borrower.

22. **Delayed payments on loans.** On occasion, IFAD borrowers pay loan instalments with a small delay, while the swaps need to be paid on the due date. In the case of a late loan payment, IFAD would temporarily have to use its liquidity to make the swap payment that is due.

23. **Mitigation.** The majority of IFAD borrowers pay in full and on time. The advance use of IFAD's liquidity to cover the swap is expected to be limited, for a relatively small amount and for a short period of time. IFAD does not charge default interest rates or apply late payment penalties on any of the loans.

IV. Communication with borrowing countries and expected demand

24. **Currently, there are 50 ordinary loans across 24 borrowers in the portfolio that meet the criteria for reference rate fixing.** The total outstanding amount of these loans was US$609 million as at 30 June 2024. Additional loans will become eligible for reference rate fixing as they reach the disbursement threshold of 50 per cent.

25. **IFAD has engaged with borrowers that would already be eligible to test preliminary demand.** These include: Angola, Argentina, Bosnia Herzegovina, China, Ecuador, Egypt, El Salvador, Eswatini, Gabon, Georgia, Indonesia, Jordan, Mexico, Montenegro, Paraguay, Philippines, Tunisia and Türkiye. Some of these countries have already enquired about the possibility of fixing the reference rate in line with the practice of other IFIs and would be interested in the option once it is available at IFAD.

26. **The experience of other IFIs indicates that about 10 to 30 per cent of borrowers with variable interest loans would be interested in rate fixing.** The interest rate conversion would be done upon the borrower's request, and it would have to fit the borrower's overall debt management strategy. IFAD's peer IFIs have found that in periods of high interest rates fewer countries are willing to fix the rate. In addition, some countries may need to consider other non-financial aspects before applying for rate fixing (e.g. if parliamentary approval is required, or the level of authority needed to request/approve rate fixing).

[7] The minimum rating is set at A- is in the Investment Policy Statement (IPS) and at A in the Investment Framework and Treasury guidelines.

Framework on IFAD Financing Conditions

I. Article I
INTRODUCTION

1. **Objective.** Article 7.1(e) of the Agreement Establishing IFAD provides, "Subject to the provisions of this Agreement, financing by the Fund shall be governed by broad policies, criteria and regulations laid down, from time to time, by the Governing Council by a two-thirds majority of the total number of votes." Eligibility for assistance is determined on the basis of objective economic and social criteria, with special emphasis on the needs of low-income countries (LICs) and their potential for increasing food production, and due regard for the fair geographic distribution of these resources. The Framework on Financing Conditions sets out the applicable criteria and conditions for this financing.

2. Since the adoption of the Lending Policies and Criteria in December 1978 by IFAD's Governing Council, IFAD has grown significantly and has seen various amendments to the Policies and Criteria for IFAD Financing. Given this evolution, it is now appropriate to have a separate Framework on Financing Conditions. The Executive Board, which is mandated to set out detailed policies governing financing by IFAD, delegates its authority to determine financing conditions under this Framework on Financing Conditions to IFAD Management.

3. The application of this Framework is limited to sovereign public sector operations and does not apply to loans funded through IFAD's non-sovereign private sector operations.[1]

[1] EB 2020/129/R.11.

II. Article II
Financing Criteria –Loans To The Public Sector

4. The criteria for determining the terms to apply to a specific country shall be as specified in this paragraph, in accordance with the following:

4.1. Developing Member States that, at the end of the year preceding the start of a replenishment period:

a. are eligible for the debt sustainability mechanism[2] shall be eligible for loans on super highly concessional terms;

b. have a gross national income (GNI) per capita lower than or equal to the operational cut-off as determined annually by the International Development Association (IDA) shall normally be eligible to receive loans from IFAD on highly concessional terms;

c. are classified by IDA as a "small state economy" shall normally be eligible for highly concessional terms;

d. have a GNI per capita higher than the operational cut-off referred to in subparagraph (b) above and are still eligible for IDA financing, shall normally be eligible for highly concessional lending terms, unless they are classified as "gap countries" or "blend countries" by IDA;

e. are classified as "gap countries" or "blend countries" by IDA shall be eligible for blend lending terms;

f. are not eligible for super highly concessional, highly concessional or blend lending terms in accordance with subparagraphs (a), (b), (c), ~~or~~ (d) or (e) shall normally be eligible to receive loans on ordinary terms;

g. are normally eligible for super highly concessional or highly concessional terms, but may be subject to less concessional terms should a remedy under the Non-Concessional Borrowing Policy (or any successor thereto), adopted by the Executive Board, be applied;

h. Countries eligible for super highly concessional, highly concessional and blend terms may access ordinary term resources through the Borrowed Resource Access Mechanism (BRAM) following a BRAM eligibility assessment.

4.2. The conditions for super highly concessional, highly concessional, and blend lending terms are as follows:

a. Loans on super highly concessional terms shall be free of interest but bear a service charge on the principal amount outstanding of a tenth of one per cent (0.1 per cent) per annum for loans expressed in special drawing rights (SDR) and as determined by the Executive Board for other currencies on a financial equivalence basis, and have a maturity period of fifty (50) years (unless a shorter maturity is requested by the borrower), including a grace period of ten (10) years, starting from the date of approval by the Executive Board.

b. Loans on highly concessional terms shall be free of interest but bear a service charge on the principal amount outstanding of three fourths of one per cent (0.75 per cent) per annum for loans expressed in SDR and as determined by the Executive Board for other currencies on a financial equivalence basis, and have a maturity period of forty (40) years (unless a shorter maturity is requested by the borrower), including a

[2] Eligibility criteria for the debt sustainability mechanism as defined in the Debt Sustainability Framework Reform (EB 2019/128/R.44).

grace period of ten (10) years, starting from the date of approval by the Executive Board.

c. Loans granted on blend terms shall: (i) be subject to a service charge on the principal amount outstanding of three fourths of one per cent (0.75 per cent) per annum for loans expressed in SDR and as determined by the Executive Board for other currencies on a financial equivalence basis; (ii) bear interest on the principal amount outstanding at a fixed rate of one and one fourth per cent (1.25 per cent) for loans expressed in SDR and as determined by the Executive Board for other currencies on a financial equivalence basis; and (iii) have a maturity period of twenty-five (25) years (unless a shorter maturity is requested by the borrower), including a grace period of five (5) years starting from the date of approval by the Executive Board.

4.3. Loans on ordinary terms shall bear interest on the principal amount outstanding based on the IFAD reference interest rate, as determined by the Executive Board in accordance with A~~a~~rticle III~~3 above~~, and have a final maturity limit (unless a shorter maturity is requested by the borrower) of up to thirty-five (35) years and a final average maturity limit of up to twenty (20) years, starting from the date on which the Fund has determined that all general conditions precedent to withdrawal have been fulfilled. The Fund's ordinary loans to Member States will be categorized as follows:

a. **Category 1** will include LICs and lower-middle-income countries (LMICs) eligible for super highly concessional, highly concessional and blend terms. These countries will be subject to the standard maturity premium differentiation, which together with the other elements of the pricing structure, will ensure a minimum cost recovery of IFAD's cost of funding the borrowed resources.

Borrowers eligible for this category will have access to resources subject to a maximum of thirty-five (35) years maturity and ten (10) years grace period, with a maximum average repayment maturity of twenty (20) years.

b. **Category 2** will include LMICs non-eligible for category 1 (already accessing semi-concessional loans), borrowers transitioning from blend terms to semi-concessional loans, creditworthy fragile and conflict-affected states, and small state economies that are eligible for borrowing from the International Bank for Reconstruction and Development. These countries will be subject to a maturity premium higher than category 1.

Borrowers eligible for this category will have access to resources subject to a maximum of thirty (30) years maturity and eight (8) years grace period, with a maximum average repayment maturity of eighteen (18) years.

c. **Category 3** will include upper-middle-income country (UMIC) borrowers with a GNI per capita below the Graduation Discussion Income (GDI) threshold that do not qualify for an exemption listed within category 2. These countries will be subject to a maturity premium higher than category 2.

Borrowers eligible for this category will have access to resources subject to a maximum of twenty (20) years maturity and five (5) years grace period.

d. **Category 4** will include UMICs with GNI per capita above the GDI threshold and less than the threshold for high-income countries (HICs), or those considered eligible for official development assistance (ODA). These countries will be subject to a maturity premium higher than category 3.

Borrowers eligible for this category will have access to resources subject to a maximum of eighteen (18) years maturity and three (3) years grace period.

5. The applicable maturity premium adjustment between income categories is reflected in the table below:

New category / average maturity	*Up to 8 years*	*Greater than 8 to 10 years*	*Greater than 10 to 12 years*	*Greater than 12 to 15 years*	*Greater than 15 to 18 years*	*Greater than 18 to 20 years*
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 state economies or in transition	0.10%	0.20%	0.30%	0.40%	0.50%	N/A
Category 3: UMICs with a GNI per capita below the GDI threshold	0.15%	0.25%	0.40%	0.50%	N/A	N/A
Category 4: UMICs with GNI per capita above the GDI threshold and less than the HIC threshold, or those considered eligible for ODA	0.25%	0.40%	0.60%	N/A	N/A	N/A

6. Spread: A variable ~~[or fixed]~~[3] spread will be applied to ordinary term loans.

7. Ordinary term loans will be offered in euros and United States dollars.

8. All loans to the public sector do not bear commitment fees.

9. <u>Borrowers of loans on ordinary terms have an option to fix the market-based reference rate that forms part of IFAD's reference interest rate in line with terms and conditions established by IFAD Management following the relevant guidelines.</u>

~~[3] The fixed spread offer is suspended from 1 January 2022 (i.e. for the Twelfth Replenishment of IFAD's Resources [IFAD12]) along with the determination of the fixed spread for ordinary term loans. In order to maintain flexibility to adapt to changes over time, the suspension of the fixed spread will be re-evaluated by the end of IFAD12 (financial year 2024). The option to reintroduce the fixed spread for ordinary term loans after re-evaluation is dependent upon the developments in: (i) the secured overnight financing rate market; and (ii) IFAD's own pricing methodology.~~

III. Article III
GOVERNANCE

10. The Executive Board, while retaining its authority to establish, from time to time, other policies and frameworks for financing that may be required or may be appropriate in order to fulfil the Fund's objectives, delegates to IFAD Management the authority to:

    10.1. determine the: (i) service charge and related interest applicable to loans on super highly, highly concessional and blend terms expressed as a unit of denomination other than SDR; and (ii) applicable fees related to loans, considering the recommendation of Management, including an analysis of the cost of preparing and administering IFAD's loans;

    10.2. determine the quarterly spread for ordinary loans to be applied over the applicable market-based rate (that together form the IFAD reference interest rate) and the terms and conditions for fixing the market-based rate; and

    10.3. every three months, review and revise the IFAD applicable spreads for the following period based on market rates.

11. The Executive Board shall have authority to approve updates to the Framework on Financing Conditions, except in instances where the update may impact the PCIF, in which case those updates will be approved by the Governing Council.

Peer Benchmark Analysis

All major IFIs offer an option to fix the variable market reference rate or a full interest rate for their variable rate loans. There is a high level of similarity across the IFIs when it comes to interest rate fixing. They all fix the rate after a partial or full disbursement of a loan when the loan repayment schedule is already known. The IFIs enter into a back-to-back interest rate swap with a market counterparty. In this way, the IFIs receive a variable reference rate to match their funding rates, which also are typically floating rates.

IFIs enter into a new swap for each loan, or for each disbursement of a loan if the loan is disbursed in multiple tranches. This minimizes the interest rate risk for the IFI, as loan cashflows are matched with the cashflows of the swap. To manage the operational burden, especially if loans have many disbursements, IFIs set the minimum disbursement threshold (minimum absolute amount or percentage of the loan) before the interest rate can be fixed. For small loans, automatic fixing at a market rate is also offered as an option, after a certain disbursement threshold is reached (e.g. US$3 million).

The IBRD and AfDB provide only reference rate fixing, while ADB provides full interest rate fixing (including the spread). In instances of full interest rate fixing, IFIs fix both the market reference rate and the spread (based on the projected spread components). In this case, the risk of a changing funding spread and other spread components is borne by IFIs. In the case of market reference rate fixing, IFIs fix only the most volatile part of the pricing while the borrowers remain exposed to changes in the other components of the variable spread. This allows the IFIs to keep passing through other elements of the spread, primarily the funding spread. At the same time, borrowers fix the most volatile part of their interest rate, which is the market reference rate. The IDB provides fixing for the reference rate and the funding spread; it fixes elements of the pricing that change every quarter, while the lending spread stays variable (in reality IDB’s lending spread stays very stable over time).

All cashflows of the swap, including swap fees are passed through from the IFI to the borrower.

A small additional fee is charged to the borrower for executing this transaction on the borrower’s behalf. The fee can be structured as a one-off up front payment or as an annual charge (0-10 bps one-off or 0-3bps per annum) to cover the operational costs. See table 1 for details.

From a legal point of view, the option of reference/interest rate fixing is reflected in the loan agreements and general lending terms of the IFI. At the time of the loan agreement signing, the pricing is always set as a variable interest rate, with an option to fix (parts of the) interest rate at disbursement or later. The borrower can request reference/interest rate fixing at the time of the disbursement or after the disbursement using a very simple form available on the IFI’s website. This form is legally binding and is sufficient to legally operationalize rate fixing.

In cases of loan prepayment, the costs of the interest rate swap unwinding would be borne by the borrower. Prepayment of the loan would be allowed only if the IFI can unwind the corresponding interest rate swap; the borrower would have to pay any corresponding costs. Should any gains result from the swap unwind, they will not be passed on by the IFI to deter speculations by the borrower. Though the swap counterparties are mostly willing to unwind the swaps, there have been some disagreements between the IFIs and the swap counterparties on valuation and execution charges. These were eventually resolved. AfDB explicitly includes in its swap documentation the provision that the loan swaps can be terminated early or adjusted in line with the underlying loan by paying the relevant market price.

In the case of a borrower defaulting on a loan, the IFI would determine its approach on a case-by-case basis depending on the outlook and the status of the negotiations with the borrower. If there is a positive outlook that the arrears can be resolved in the near future, the IFI would keep the swap outstanding and fund payments using equity until the borrower is current or the loan has been restructured. If not, the IFI would terminate the swap and pass on the cost (if any) to the borrower. When the swap is terminated, the loan reverts back to the floating rate.

To the contrary, in a case where the swap counterparty defaults, IFIs assume the risk of an early termination of the interest rate swap. If the swap counterparty defaults at any point in the future before the period of the rate fixing ends, the IFI would need to enter into a new swap to re-hedge itself. All major IFIs have one-way credit support annex (CSA) arrangements with the swap counterparties, which offer some protection. However, any re-hedging costs would be borne by the IFI.

Interviews were conducted with the IBRD, AfDB, ADB and IDB to better understand their rate fixing option. There is considerable similarity among the IFIs in terms of the offer, with some nuances. Table 1 below summarizes the key parameters of their offering.

Table 1
Summary of rate fixing option provided by peer IFIs

	IBRD	AfDB	ADB	IDB
Variable rate product	IBRD Flexible Loan (IFL)	Fully flexible loan (FFL)	Flexible Loan Product (FLP)	Flexible financing facility (FFF)
Pricing formula	Reference rate + funding spread + maturity premium + contractual spread	Reference rate + funding spread + maturity premium + lending margin	Reference rate + funding spread + maturity premium + contractual spread	Reference rate + funding spread + lending spread
Type of fixing	Reference rate	Reference rate	Full interest rate fixing	Reference rate + funding spread
Time of fixing	At the time of or after the disbursement	At the time of or after the disbursement	At the time of or after the disbursement	At the time of or after the disbursement
Automatic fixing	Yes, for small loans after the disbursement threshold is hit	Yes, for small loans after the disbursement threshold is hit	Yes, for any loans	Not available
Early termination due to loan prepayment	Prepayment conditional on swap unwinding. All costs passed on to the borrower, but gains not	Prepayment conditional on swap unwinding. All costs passed on to the borrower but gains not. Swap documentation includes early termination provisions	Prepayment conditional on swap unwinding. All costs passed on to the borrower	Prepayment conditional on swap unwinding. All costs passed on to the borrower
Early termination due to borrower's default	Decision case-by-case. If arrears can be resolved the swap is kept. If not, swap is unwound and the costs passed on to the borrower	Decision case-by-case. If arrears can be resolved the swap is kept. If not, swap is unwound and the costs passed on to the borrower	Decision case-by-case. If arrears can be resolved the swap is kept. If not, swap is unwound and the costs passed on to the borrower	No experience with default so far. Would decide case-by-case.
Early termination due to swap counterparty default	Risk taken by IBRD. It would re-hedge by entering the new swap.	Risk taken by AfDB. It would re-hedge by entering the new swap.	Risk taken by ADB. It would re-hedge by entering the new swap.	Risk taken by IDB. It would re-hedge by entering the new swap.
Pricing	Pass-through of the fixed market rate (including associated swap costs)	Pass-through of the fixed market rate (including associated swap costs)	Pass-through of the fixed market rate (including associated swap costs)	Pass-through of the fixed market rate (including associated swap costs)
Fees	5 bps for US$ up front 10 bps for other currencies up front	0 bps for initial reference rate fixing 3bps per annum for additional unfixing/fixing	0 bps for initial reference rate fixing 6.25 bps up front for additional unfixing/fixing	1 bps per annum for any fixing/unfixing
Other similar option offering	Collar Cap Currency conversion	Collar Cap Currency conversion	Collar Cap Currency conversion	Collar Cap Currency conversion