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Enabling the rural poor
to overcome poverty

Proposed arrangements for implementation of a debt sustainability framework at IFAD

Executive Board — Ninetieth Session
Rome, 17-18 April 2007

For: **Approval**

Note to Executive Board Directors

This document is submitted for approval by the Executive Board.

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Recommendation for approval

In the light of the recommendations of the Report of the Consultation on the Seventh Replenishment of IFAD's Resources, adopted by the IFAD Governing Council at its twenty-ninth session on 16 February 2006, and the expressed commitment of IFAD Member States, and particularly those that are major contributors of official development assistance, to compensate IFAD within a pay-as-you-go mechanism as adopted under the fourteenth replenishment of the International Development Association, as well as the considerations presented in this document, it is recommended that:

- (a) IFAD immediately implement a debt sustainability framework (DSF) to govern the form of its financial assistance to countries eligible for highly concessional lending;
- (b) IFAD use the classification of countries in terms of debt sustainability as produced by the World Bank and the International Monetary Fund in their country debt sustainability analyses;
- (c) IFAD extend financial support projects and programmes governed by the performance-based allocation system (PBAS) in countries eligible for highly concessional loans on the following basis:
 - (i) For countries with low debt sustainability: 100 per cent grant
 - (ii) For countries with medium debt sustainability: 50 per cent grant and 50 per cent loan
 - (iii) For countries with high debt sustainability: 100 per cent loan;
- (d) In the context of the implementation of the DSF, IFAD apply a modified volume approach involving a discount of 5 per cent of the value of DSF grants extended. The proceeds of this discount will be reallocated to augment PBAS allocations according to PBAS allocation rules;
- (e) IFAD participate in consultations with other multilateral financial institutions on the operation of the DSF, and will propose to the Executive Board any changes in the implementation of the DSF at IFAD as and when required to maintain harmony with the practices of the International Development Association;
- (f) Commencing in 2008, IFAD report annually to the Executive Board at its April session on the estimated principal and net service and interest charge payments forgone in the previous financial year as a result of the implementation of the DSF;
- (g) In support of the implementation of the pay-as-you-go compensation mechanism associated with the IFAD replenishment process, IFAD prepare for each replenishment consultation, commencing with the Eighth, an estimate of the principal payments forgone as a result of the implementation of the DSF in the then current replenishment period; and
- (h) In the context of the Consultation on the Eleventh Replenishment of IFAD's Resources, IFAD prepare and present a paper on its experience and the experience of other multilateral financial institutions since their adoption of the DSF, with regard to actual and estimated net losses in service charge payments, and present proposals on future approaches to compensation as required.

Executive summary

1. In the context of IFAD's full commitment to the international effort to reduce the impact of unsustainable debt on the pace of poverty reduction (through its participation in the Debt Initiative for Heavily Indebted Poor Countries), and of the global emphasis on the harmonization and alignment of development assistance, the Report of the Consultation on the Seventh Replenishment of IFAD's resources, adopted by the IFAD Governing Council at its twenty-ninth session, recommended that, commencing in 2007, IFAD should adopt the International Development Association (IDA) model of a debt sustainability framework (DSF) to govern the allocation of assistance to countries eligible for highly concessional assistance and with high to moderate debt-distress risk. It was further decided that IFAD management should submit to the Executive Board in September 2006 proposals for the operation of the debt sustainability framework, including provisions for: reporting on progress; the share and implications for IFAD's finances; the implications for IFAD's disbursements to developing countries; the implementation of the appropriate modified volume approach for the generation of compensation for service charges forgone; and IFAD's participation in the collaboration among multilateral financial institutions (MFIs) for refining and reviewing methodologies used under the debt sustainability framework, as well as calibration of IFAD's approach with the approaches of other such institutions. Given that the finalization of IFAD's proposals for implementation of the DSF depended upon the outcome of the review of DSF methodology in the mid-term review of the fourteenth replenishment of IDA, submission of IFAD's proposals to the Executive Board was deferred to its April 2007 session.
2. It is recommended inter alia that:
 - (a) IFAD immediately implement a DSF to govern the form of its financial assistance to countries eligible for highly concessional lending;
 - (b) IFAD use the classification of countries in terms of debt sustainability as produced by the World Bank and the International Monetary Fund in their country debt sustainability analyses;
 - (c) IFAD extend financial support projects and programmes governed by the performance-based allocation system (PBAS) in countries eligible for highly concessional loans on the following basis, in line with IDA and the African Development Fund (ADF):
 - (i) For countries with low debt sustainability: 100 per cent grant
 - (ii) For countries with medium debt sustainability: 50 per cent grant and 50 per cent loan
 - (iii) For countries with high debt sustainability: 100 per cent loan.
3. The implementation of the DSF at IDA and ADF involves the application of a modified volume approach (MVA) whereby the part of a country's PBAS allocation delivered in the form of a DSF grant is discounted by 20 per cent. This serves to maintain the performance linkage with the resource allocation system and to generate resources for a mechanism of compensation for service charges forgone. It is proposed that at IFAD a 5 per cent discount level be applied, in order to maintain PBAS principles but minimize the impact of the DSF on up-front flows of assistance to the poorest and often most vulnerable countries.
4. Under IDA 14 and ADF 10, the DSF was adopted within the framework of zero impact on the resource position of the participating MFIs. Correspondingly, IFAD would be compensated for principal repayments forgone as a result of extending support on a grant basis under the DSF. As in IDA 14 and ADF 10,

this would be on a pay-as-you-go basis, with Member States compensating IFAD in each replenishment for the value of principal repayments forgone in the previous replenishment period through contributions in addition to core replenishment contributions. IFAD would generate compensatory flows for the loss of service charge income through the operation of the MVA. The adequacy of the mechanism relative to the objective of zero overall financial impact of the DSF on IFAD would be assessed in the context of the Consultation on the Eleventh Replenishment of IFAD's Resources.

Proposed arrangements for implementation of a debt sustainability framework at IFAD

I. Background

1. The debt sustainability framework (DSF) is part of the architecture of multilateral financial institutions' (MFIs) support for debt relief and management in the poorest countries. The DSF was introduced more or less contemporaneously in the context of the negotiations of the fourteenth replenishment of the International Development Association (IDA) and the tenth replenishment of the African Development Fund (ADF), subsequent to the implementation of the Debt Initiative for Heavily Indebted Poor Countries (HIPC) but prior to the implementation of the Multilateral Debt Relief Initiative (MDRI). Reflecting the extremely negative impact of high levels of external debt on the efforts of poor countries to accelerate poverty reduction, under the HIPC and MDRI initiatives very significant resources have been committed to debt reduction. The DSF is designed to ensure that the poorest countries' development efforts are not compromised by the re-emergence of unsustainable debt levels – by providing new development assistance to them on terms consistent with achieving and maintaining sustainable levels of debt and by supporting debt management at the country level. Whereas the HIPC and MDRI initiatives deal with the stock of debt, DSF helps to manage future debt accumulation. Nonetheless, the two debt relief initiatives have substantially affected the material scope of the DSF by virtue of the major reduction they have achieved in the debt overhang of the poorest countries.
2. The DSF works within the framework of the performance-based allocation systems (PBAS) of IDA and ADF: the PBAS determines the level of country allocations, while the DSF determines the financing format for those allocations, i.e. in the form of grants or a mix of grants and loans to countries with low or medium debt sustainability. As agreed in the context of IDA 14 and ADF 10, and (in the case of IDA) on the basis of country debt sustainability analyses produced by the World Bank and International Monetary Fund (IMF):
 - (a) Poor (i.e. IDA- and ADF-eligible) countries with low debt sustainability ("red light" countries) receive assistance from IDA and ADF on 100 per cent grant terms
 - (b) Poor countries with medium debt sustainability ("yellow light" countries) receive assistance on 50 per cent grant terms
 - (c) Poor countries with high debt sustainability ("green light" countries) receive assistance on 100 per cent loan terms.
3. In order to preserve the principle of positive rewards for performance, and in order to provide an internal platform for compensation for operation of the DSF (see below), IDA applies a modified volume approach (MVA) to PBAS allocations under its DSF. Specifically, the element of PBAS allocations provided in the form of grants according to the DSF rules is nominally discounted by 20 per cent. In effect, however, the IDA discount is approximately 14 per cent: 9 per cent retained to cover part of DSF service charge costs, plus approximately 5 per cent arising from the redistribution of part of the nominal discount to non-grant receiving countries and return of a portion to grant-receiving countries themselves.
4. Implementation of the DSF will raise the proportion of grants in IDA assistance programmes, and, ceteris paribus, it will lower the long-term financial inflows of IDA (and of any other MFI implementing a DSF) because of loss of principal repayments and proceeds from service charges. The IDA 14 and ADF 10 replenishment agreements affirmed the principle of no-loss to IDA and ADF from the operation of a DSF, and agreed on compensation mechanisms. The major cost to MFIs

implementing a DSF is the principal repayment forgone on resources that are given as grants rather than loans. The IDA 14 and ADF 10 replenishments agreed on full compensation by the replenishment members for actual "loss" of principal repayments on a pay-as-you-go basis (i.e. in the form of the commitment of Member States to contribute additional resources – over and above core replenishment support – to future replenishments equivalent to the loss of principal repayments occasioned by application of the DSF in the previous replenishment period). In addition, IDA and ADF were authorized to use a complex scheme for compensation for lost service charges, based on using a retained element of the MVA discount in blended loan operations. Together, these mechanisms are intended to provide 100 per cent coverage for lost MFI resource flows stemming from the DSF.

5. In the context of IFAD's full commitment to the international effort to reduce the impact of unsustainable debt on the pace of poverty reduction (through its participation in the HIPC Debt Initiative), and of the global emphasis on the harmonization and alignment of development assistance, the Report of the Consultation on the Seventh Replenishment of IFAD's Resources, adopted by the IFAD Governing Council at its twenty-ninth session, on 16 February 2006 recommended that:
 - (a) Commencing in 2007, IFAD should adopt the IDA model of a debt sustainability framework to govern the allocation of assistance to countries eligible for highly concessional assistance and with high to moderate debt-distress risk.
 - (b) The relevant articles of the Agreement Establishing IFAD should be amended to allow the operation of the debt sustainability framework.
 - (c) The debt sustainability framework adopted by IFAD should be based on technical economic country analyses (indicative debt burden thresholds) of debt-distress risk (and, eventually, 20-year forward-looking analyses of debt sustainability) produced by the relevant international institutions competent in that area, i.e. IMF and the World Bank, working in collaboration with the countries concerned.
 - (d) IFAD Member States, and particularly those that are major contributors of official development assistance, should agree to compensate IFAD fully for principal repayments forgone as a result of application of the debt sustainability framework within a pay-as-you-go mechanism as adopted in IDA 14.
 - (e) IFAD management should submit to the Executive Board in September 2006 proposals for the operation of the debt sustainability framework, including provisions for: reporting on progress; the share and implications for IFAD's finances; the implications for IFAD's disbursements to developing countries; the implementation of the appropriate modified volume approach for the generation of compensation for service charges forgone; and IFAD's participation in the collaboration among MFIs for refining and reviewing methodologies used under the debt sustainability framework, as well as calibration of IFAD's approach with the approaches of other MFIs.
6. At the time of adoption of these recommendations, the Governing Council also amended the relevant provisions of the Agreement Establishing IFAD to allow for the operation of the DSF.
7. Subsequent to the adoption of the consultation report, a number of important developments took place or were planned to take place, including the entry into effect of the MDRI at IMF, IDA and the African Development Bank (AfDB); and the review of the methodology for assessment of debt sustainability in the context of the IDA 14 mid-term review.

8. Given that IFAD's implementation and assessment of the cost of the DSF were dependent upon the resolution of pending issues at IDA, and that resolution of these questions was expected during the third and fourth quarters of 2006, the presentation of IFAD's proposals for the operation of a DSF at IFAD was deferred to the April 2007 session of the Executive Board. This was consistent with the position of the Asian Development Bank, which also awaited final clarification of the IDA methodology to prepare an options paper for the ninth replenishment of the Asian Development Fund mid-term review.
9. To date, the DSF has been fully implemented by IDA and ADF under IDA 14 and ADF 10, respectively. The IDA 14 mid-term review confirmed the overall approach (e.g. three-level classification and the grant element level in qualifying debt-vulnerable countries), and authorized the expected shift to forward-looking debt sustainability analysis (which should provide for less volatile debt sustainability classifications). Currently, IDA estimates that 21 per cent of its country support will be delivered in the form of grants. As yet, the pay-as-you-go compensation mechanism has not been tested, and will not be triggered for some years because of the grace period on IDA loans.

II. Considerations for the implementation of the DSF at IFAD

MVA discount rate

10. IFAD's comparative advantage lies in the analysis of rural poverty, not in the analysis of macroeconomic vulnerabilities. Moreover, it is imperative that development assistance be provided within aligned and harmonized approaches. Consequently, the Governing Council in 2006 determined that IFAD would implement a DSF on the basis of debt sustainability analyses produced by the World Bank and IMF. However, the Governing Council, in adopting the Consultation's recommendations, also drew specific attention to the issue of the implementation of an MVA at IFAD by making reference to implementation of an **appropriate** modified volume approach (boldface added). The discount **level** and mechanism adopted in the MVA of each participating institution reflect decisions about the appropriate balance among its own objectives: it is not rule-based and intrinsic to the DSF. The critical dimensions of a DSF embrace a common identification of at-risk countries, and a common approach to financing on a grant basis in high and medium vulnerability situations. The operation of the MVA is something that each institution must determine on the basis of its own structure, possibilities and objectives.
11. As indicated above, under its DSF, IDA discounts (MVA) 20 per cent of the value of DSF grants to IDA-eligible countries with problematic debt sustainability: 9 per cent is retained by IDA for the compensation mechanism (through blended lending), and 11 per cent is redistributed among all countries. IDA is a very important source of public finance for many of its borrowers – and the 20 per cent level is intended to give a strong signal about, inter alia, the benefits of good public financial management.
12. At IFAD, unlike at IDA, the weight of the assistance programme is not such as to provide meaningful signals about good debt management through the implementation of its MVA, although it is important to sustain the principle of positive rewards to performance that underpins the PBAS at IFAD. On the other hand, the objective of maximizing resource flows to the undersupported area of rural development and poverty reduction is paramount. Given that (a) adoption of a high discount rate under the MVA at IFAD would significantly reduce the up-front flow of resources to some of the poorest and most vulnerable countries (the implementation of a DSF at IFAD in 2007 would, indicatively, involve provision of assistance on 100 per cent grant terms to Burundi, Cambodia, Comoros, Guinea, Guinea-Bissau, Kyrgyzstan and Sierra Leone – and on 50 per cent grant terms to Angola, Ethiopia, Lesotho, Malawi, Nicaragua and Tajikistan); (b) a high discount rate would challenge

the ability of IFAD to maintain the level of resource commitment to sub-Saharan Africa because the discounting would be heavily focused on countries in that region (9 of 14 African countries in the indicative 2007 IFAD programme of work are in the "red light" and "yellow light" categories as per the current World Bank/IMF classification); and (c) the intensity of IFAD's subscription to the message about the importance of good debt management will have a limited impact on debt management practices, it is arguable that the MVA discount rate at IFAD should be positive, but also that it should be considerably less than the 20 per cent applied by IDA. On the basis of these considerations, it is recommended that a 5 per cent discount level be applied at IFAD – to maintain PBAS principles but minimize the impact of the DSF on up-front flows of assistance to the poorest and often most vulnerable countries.

Placement of the proceeds of the MVA discount mechanism

13. At IDA, 9 per cent of the discounted 20 per cent (of the PBAS allocations delivered in the form of grants) is placed in blended lending operations, and the remaining 11 per cent is returned for allocation through the PBAS system. IFAD does not engage in loan blending operations, and the entirety of the proceeds of the implementation of an MVA discount at IFAD should be reallocated through the mechanism adopted for the remaining half of the MVA discount in IDA itself, i.e. should be reallocated through the PBAS system.

Costs to IFAD

14. Implementation of a DSF at IFAD would have no impact on the majority of its development assistance: the PBAS would continue to determine country assistance allocations; the financing terms of assistance to countries eligible for ordinary and intermediate terms would remain unchanged; and only part of the assistance that in the absence of a DSF would be provided on highly concessional terms would be provided on a grant basis in a with-DSF scenario. As indicated above, the shift of a portion of assistance from highly concessional lending to grant terms would have an impact on the Fund's future resource flows, necessitating invocation of the general principle of the DSF that its implementation should be cost-neutral to the MFIs involved, and that MFIs should be compensated fully for forgone principal and service charge repayments through a combination of pay-as-you-go compensation linked to the replenishment process and the income generated through the application of the MVA.
15. No participating MFI is in a position to give precise estimates of the costs of its DSF, given the impossibility of predicting the future debt sustainability status of individual countries – and the fact that the volume of future grants will be tied to the size of future programmes of work, country performance against PBAS criteria, etc. Consequently, the financial neutrality of a DSF for MFI finances is ultimately guaranteed by the robustness and flexibility of the commitment to compensation made by their members.
16. At best, estimates can be made of the possible magnitude and timing of costs. In the case of IFAD, the approach has been to estimate the impact of the DSF on the profile of financing terms for IFAD's programmes of work for the seventh replenishment period (based on IFAD's published PBAS allocations and current country debt sustainability classifications), and then to calculate the medium- and long-term impact of this change by applying the same profile to the programmes of work under future replenishments.
17. Two scenarios are analysed: DSF at 5 per cent and at 20 per cent MVA discounts, applying the approach to country grants adopted by IDA. The table below presents the difference in resource flows that this new distribution of financing terms in the programme of work would generate in IFAD's principal repayments received and service charge payments received (reflecting the balance over time between the losses arising from the higher percentage of grants in the programme of work, on

the one hand, and the higher percentage of financing on ordinary and intermediate terms, on the other). These are the two headings of loss for which compensation mechanisms were provided under IDA 14 and ADF X. The table indicates the financial impact under these headings in each replenishment period up to and including the eleventh replenishment of continuing application of the DSF under the two scenarios (i.e. MVA discount at the 5 and 20 per cent levels).

Scenarios for the loss of principal repayments and service charge payments as a result of the implementation of a DSF at IFAD

(millions of United States dollars)

<i>Replenishment period</i>	<i>Forgone principal payments</i>		<i>Forgone service charge payments</i>	
	<i>MVA at 5%</i>	<i>MVA at 20%</i>	<i>MVA at 5%</i>	<i>MVA at 20%</i>
Seventh	-	-	-0.02	0.01
Eighth	-	-	-0.28	0.21
Ninth	-	-	-1.95	-0.39
Tenth	-3.90	-3.50	-5.48	-2.53
Eleventh	-38.77	-34.87	-10.30	-5.96

18. Given the grace period on principal repayment under IFAD's highly concessional loans, the implementation of the DSF would have no impact on principal payments in the seventh, eighth and ninth replenishment periods, and an immaterial impact on the service charge account. Thereafter, IFAD would lose principal repayments – at the level of US\$38.77 million over the eleventh replenishment period under a 5 per cent MVA discount (or US\$34.87 million under a 20 per cent discount). On the service charge payment side, the net effect would be modest up to and including the eleventh replenishment period. At an MVA discount of 5 per cent and a recent record of commitment of over 80 per cent of loans on highly concessional terms, the overall shift of the loan and grant programme from countries eligible for highly concessional lending and DSF grants would be unlikely to exceed 1-1.5 per cent of the programme of work.

III. Future evolution of the DSF

19. The DSF is a new mechanism in the international development architecture, and it is likely that it will need to evolve in future in response to the experience of its implementation as well as to changing configurations of poor country indebtedness and debt management. Given the concern that approaches to the implementation of the DSF be harmonized among MFIs, IFAD would continue to participate in the MFIs' DSF information and coordination process that has developed around HIPC Debt Initiative implementation and financing.