

Document: EB 2009/98/R.14  
Agenda: 10(b)  
Date: 23 November 2009  
Distribution: Public  
Original: English

**E**



Enabling poor rural people  
to overcome poverty

**IFAD's lending terms and conditions:  
Interest rate for the year 2010 for  
loans on ordinary and intermediate  
terms**

Executive Board — Ninety-eighth Session  
Rome, 15-17 December 2009

---

For: **Information**

## **Note to Executive Board Directors**

This document is submitted for the information of the Executive Board.

To make the best use of time available at Executive Board sessions, Directors are invited to contact the following focal point with any technical questions about this document before the session:

**Bambis Constantinides**

Director, Financial services Division

telephone: +39 06 5459 2054

e-mail: [c.constantinides@ifad.org](mailto:c.constantinides@ifad.org)

Queries regarding the dispatch of documentation for this session should be addressed to:

**Deirdre McGrenra**

Governing Bodies Officer

telephone: +39 06 5459 2374

e-mail: [d.mcgrenra@ifad.org](mailto:d.mcgrenra@ifad.org)

## **IFAD's lending terms and conditions: Interest rate for the year 2010 for loans on ordinary and intermediate terms**

### **A. Background**

1. Paragraph 33(a) of the Lending Policies and Criteria stipulates that the Executive Board shall:
  - (a) Determine, on the basis of the variable ordinary interest rate of international financial institutions (IFIs) concerned with development, the reference rate of interest for application in IFAD, which shall provide the basis for the review and revision prescribed in subparagraph (b) below; and
  - (b) Decide, annually, the rate of interest to be applied, respectively, to loans on intermediate and ordinary terms. For that purpose, it shall review annually the rates of interest applicable to loans on intermediate and ordinary terms and revise such rates, if necessary, on the basis of the reference rate of interest in effect on 1 July of each year.
2. In September 1995, the fifty-fifth session of the Executive Board approved document EB 95/55/R.45 authorizing the President to establish the IFAD rates of interest routinely on the basis of the July-December variable interest rate of the International Bank for Reconstruction and Development (IBRD), without prior Board approval, but on the understanding that the Board would be notified of the rates so established.
3. In 2007, the IBRD executive board approved a significant simplification and reduction in IBRD loan and guarantee pricing by setting the IBRD variable interest rate based on the London Interbank Offered Rate (LIBOR).
4. In September 2008, IFAD adopted the special drawing right (SDR) LIBOR 12-month composite rate as the reference interest rate in 2009 for IFAD loans on intermediate and ordinary terms, rather than the IBRD-published currency pool rate, the rate that had been applied until that time.
5. In September 2009, at its ninety-seventh session, the Executive Board approved document EB 97/R.46/Rev.2 setting out the following modifications to the previous lending terms:
  - (a) That the periodicity of the update of the IFAD reference interest rate be amended from 12 months to 6 months on the basis that IFAD is moving into line with practices currently applied by other international financial institutions;
  - (b) That the applicable rate will be based on the SDR LIBOR six-month composite rate, with due regard to IFAD's unique mandate;
  - (c) That the Board will henceforth be informed of the applicable interest rate through publication on the IFAD website; and
  - (d) That the amendment will take effect as of January 2010.
6. The Board requested further clarification on the practices of other IFIs, the proposed methodology, and the long-term implications of the revisions. This document provides additional information on these aspects.

## B. The practices of other international financial institutions

### IFAD compared with other international financial institutions

7. As a Fund, IFAD relies on replenishment contributions, supplemented by investment income and loan interest/reflows, to finance its lending activities, grants, and programme management and administrative costs.
8. The other main development IFIs with similar operations to those of IFAD (the World Bank, African Development Bank [AfDB], Asian Development Bank [AsDB] and Inter-American Development Bank [IDB]) generally have a dual organizational and funding structure: the "bank" entity, which is primarily financed through capital provided by their shareholders and borrowing from the market; and the "fund" entities, which are mainly financed through replenishments. The fund entities typically provide loans on highly concessional terms, while non-concessional lending is provided by the bank entities. Consequently, the pricing of the lending products provided by the Bank entities (i.e. interest rates applied) is closely linked to the cost of their financing.

### Lending products offered by the IFIs

9. The main IFIs (IBRD, AsDB, AfDB, IDB) offer their borrowers a wider variety of lending products than IFAD. These include loans with fixed or variable rates plus a fixed or a variable spread and flexibility also as regards the loan currency and the maturity and grace periods. For the purposes of this paper, the analysis was limited to products that are similar to IFAD's:
  - (i) loans on ordinary terms that have a variable reference interest rate and a maturity period of 15 to 18 years, including a grace period of three years; and
  - (ii) loans on intermediate terms that have a rate of interest equivalent to 50 per cent of the variable reference interest rate and a maturity period of 20 years, including a grace period of five years.
10. **Ordinary terms.** The lending product offered by IFIs that is comparable with the IFAD ordinary term loan is the variable base rate loan, i.e. loans for which the applicable interest rate is not fixed at the outset but is reset at regular intervals throughout the life of the loan. The applicable interest rate is normally based on the six-month LIBOR plus a spread (i.e. percentage added to the applicable rate) and is reset twice a year for most IFIs. Other features such as repayment maturity and grace periods or applicable charges (such as commitment and front-end fees) vary among IFIs.
11. Table 1 below shows the most recent spread structures adopted by the main multilateral development banks for United States dollar-denominated variable base rate loans, as published on their websites.

Table 1

Interest spread	IBRD	IDB <sup>a</sup>	AfDB	AsDB
Contractual spread	50	40	40	20
Funding cost margin	-33	- <sup>b</sup>	+4	-31 <sup>c</sup>
<b>Net spread over LIBOR</b>	<b>17</b>	<b>40</b>	<b>44</b>	<b>-11</b>

<sup>a</sup> The IDB uses the three-month LIBOR rate as its base rate for similar loans and adjusts the interest rate every three months.

<sup>b</sup> The IDB applies as a funding cost margin the weighted average cost margin allocated to the specific product category (the exact figure was not available on the IDB website).

<sup>c</sup> The AsDB funding cost margin is issued in the form of a rebate.

12. The funding cost margin reflects the IFIs' cost of borrowing, i.e. the primary source of funding for the products offered by the IFI "bank" entities. The negative sign indicates that the IFIs can borrow at rates below the LIBOR market rates due to their sound AAA credit ratings. The contractual spread is determined by each

institution considering many factors, including the costs, and is regularly updated and aligned with the prevailing funding needs of each institution. This pricing methodology cannot be readily applied to IFAD since the Fund cannot calculate a funding cost margin in the same way as the other institutions, (the Fund does not borrow from the markets and the primary source of funding for its ordinary/intermediate term loans is the same as for its highly concessional lending, i.e. replenishment contributions).

### **Intermediate terms**

13. Other IFIs do not offer loan products that are directly comparable with the IFAD loans on intermediate terms. Some IFIs, however, offer borrowers that have recently graduated from concessional lending, products with terms falling between the IFAD ordinary and highly concessional terms. In the case of the World Bank, for instance, IDA offers "hardened terms" loans to borrowers falling into this group. The interest rates applied to such loans are the same service charges that apply to IFAD highly concessional loans, while the maturity limits are similar to those applied for IFAD ordinary term loans. IFAD will propose the introduction of a similar product in 2010.

## **C. Methodology for determining the IFAD reference interest rate for 2010**

14. The Governing Council decided in 1994 that IFAD should determine its lending rate on the basis of the variable ordinary interest rate of IFIs concerned with development. This decision was based on an assessment of the distinct nature, mandate and needs of the Fund. In particular, the decision was motivated inter alia by the need to: maintain a high degree of concessionalism in lending to poorer countries; allocate a relatively large proportion of total lending to loans on highly concessional terms; balance the high average grant element in IFAD lending (concessionalism) with the long-term viability of the Fund as required by the provisions of article 7 of the Agreement Establishing IFAD; and have lending terms and conditions in line with those of other IFIs and the international capital markets. In 1994, the Executive Board decided that the IFAD reference rate would be the variable interest rate of the IBRD. This option was chosen for the reason that IBRD is a global institution and borrows globally to finance its lending operations and, therefore, its variable interest rate reflects the cost of money borrowed worldwide.
15. Establishing a reference rate, as decided by the Governing Council and the Executive Board, has ensured transparency of methodology for borrowers and has facilitated both cofinancing and harmonization of approaches in the same sector. Using the IBRD variable interest rate as IFAD's reference rate makes it easy for the Fund to establish its rates in a transparent and timely fashion.
16. The significant developments in recent years in the financial markets and in the lending terms of IFIs – particularly the World Bank – have necessitated changes in IFAD lending terms but have not diminished the need to align these with those of the other IFIs. Based on these considerations, Management reaffirmed the principle of alignment with the IBRD variable interest rates.
17. The IBRD product that resembles the IFAD ordinary term loan is the IBRD variable spread loan – a type of variable base rate loan. The main characteristics of this loan (not all applicable to IFAD) as compared with the IFAD ordinary term loan for 2010 are listed below.

<i>IBRD Variable Spread Loan</i>	<i>IFAD Ordinary Terms</i>
Semi-annual reset of interest rate equal to six-month LIBOR plus a variable spread also reset twice a year	Semi-annual reset of interest rate based on six-month LIBOR
A one-time front-end fee charged at the beginning of the project (currently 0.25 per cent)	No front-end fee
Average maturity of 18 years (maximum 30) including a grace period	Maximum maturity 18 years including a grace period
Choice of currency (main currencies)	Available only in SDR

18. When IFAD introduced LIBOR in 2008, the spread of the IBRD variable spread loan was almost zero. The variable IBRD spread for this type of loan has since increased. Consequently, IFAD will determine its reference interest rate by applying a composite spread directly derived from the IBRD variable spread for the four SDR currencies to the six-month composite SDR LIBOR rate. The spread will be a weighted average of the variable spread applied by the IBRD for the four SDR currencies on 1 January and 1 July each year. This approach preserves the basic principle of alignment to the IBRD rates and ensures transparency and predictability in IFAD's pricing practices. The IFAD reference interest rate will be published on the IFAD website as soon as possible after 15 January 2010 (time lag due to the timing of the publication of the IBRD variable spread).
19. Based on September 2009 IBRD rates, the IFAD composite SDR variable spread would be 0.17 per cent and the interest rate for ordinary term loans would be 0.94 per cent (SDR LIBOR at 0.77 per cent plus 0.17 per cent). The interest rate for intermediate loans would be 0.47 per cent, i.e. lower than the service charge of 0.75 per cent applied by IFAD to highly concessional loans. This is not inconsistent with the comparative concessionalism of the different classes since highly concessional borrowers are guaranteed a very low fixed rate for a period of 40 years. Intermediate/ordinary term borrowers would have to pay a significant premium (currently higher than 3 per cent per annum on average for SDR currencies) to have a guaranteed fixed-interest rate over the life of their loans. The current IBRD interest rate for new United States dollar loans is 0.65 per cent.
20. This methodology will be applied for calculating the IFAD reference interest rate in 2010. The Fund will, however, have to continue reviewing actively this approach in 2010 and beyond. The IBRD continuously develops the range and characteristics of its products and it may no longer be possible or appropriate to compare directly the terms attached to any specific IBRD product with IFAD ordinary/intermediate term loans, also considering IFAD's specific mandate. It is therefore possible that in the future, the rate applied by IFAD may be higher or lower than the IBRD rate. In modifying the approach, the Fund will seek guidance from the Board and will be guided by factors of both supply (the cost of funding) and demand (the need for financing in the area of IFAD's mandate).

#### **D. Long-term implications of the revisions**

21. The revisions to take effect apply to IFAD loans on intermediate and ordinary terms and comprise the following:
- The periodicity of the update of the IFAD reference interest rate will be amended from 12 months to 6 months;
  - The applicable rate will be based on the SDR LIBOR six-month composite rate (instead of the SDR LIBOR 12-month composite rate);
  - Until decided otherwise, IFAD will apply a composite spread directly derived from the IBRD variable spread for the four SDR currencies to the six-month composite SDR LIBOR rate.

22. The impact of (a) above is expected to be purely on the timing of flows. This is not expected to have a long-term impact on IFAD's liquidity or resource adequacy.
23. Revision (b) above will probably have a negative effect on IFAD interest income since the LIBOR six-month rate is normally lower than the LIBOR 12-month rate. The application of a spread above the LIBOR rate as per revision (c) above will have a positive impact on interest income since the IBRD spread is currently positive. A long-term calculation of the net effect of these two elements is not possible since the fluctuations of the two elements are not predictable.
24. An indication of the potential impact can be provided by the amounts involved. The interest income from affected IFAD loans (approximately 7 per cent of all active outstanding loans in terms of amount) is estimated at approximately US\$10 million for 2009. Without applying the revisions (a), (b) and (c), the relevant figure for 2010 would be approximately US\$3 million due to the significant decline in SDR interest rates. Based on current values, the net effect of 2010 interest income of revisions (b) and (c) above would be approximately a negative US\$0.5 million. The comparative impact of this on IFAD resources and liquidity is not significant when compared with the IFAD total loan reflows figure, which for 2010 is estimated to be approximately US\$250 million.
25. The analysis provided in this paper is limited to the methodology for the setting of agreed interest rates. As indicated above, the possibility of introducing modifications or variations to IFAD lending terms and products will be kept under active review and will be further elaborated in the context of the development of a policy for middle-income countries and in revising the IFAD Lending Policies and Criteria, taking into account IFAD's specific mandate and nature.