

Corporate-level Evaluation on IFAD's Financial Architecture

101st session of the Evaluation Committee

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Independent Office of Evaluation

IFAD
Investing in rural people

An overview of the main inflow and outflow of IFAD's financial resources

Funding sources (non reimbursable)

- Replenishment contributions
- Loan reflows & interest
- Complementary contributions
- Income from treasury investments
- Supplementary Funds
- Compensation for DSF & HIPC

Funding sources (reimbursable)

- Sovereign borrowing
- Concessional partner loans

Utilization of funds - rural poverty reduction

- Loans and DSF Grants
- Grants
- Reimbursable TA

Utilization of funds - expenses

- Operating expenses
- Repayment of sovereign loans

Sources of funds

- IFAD traditionally relied on: (i) replenishment contributions; (ii) loan reflows & interest; and (iii) treasury investment income

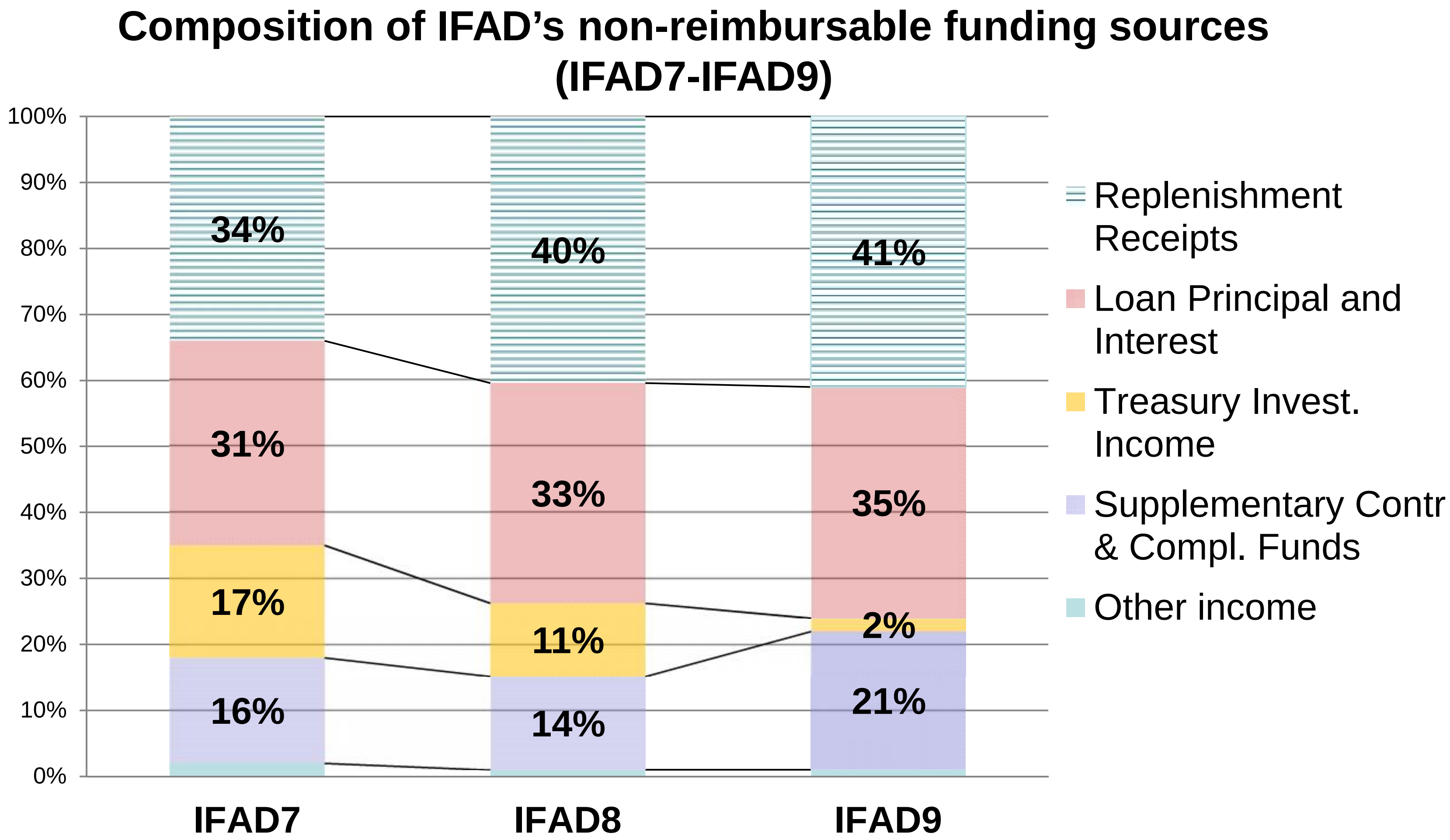
- Additionally, complementary contributions and supplementary funds

- Between IFAD7 and IFAD9

  - ➢reliance on replenishment contributions increased

  - ➢Income from treasury investment decreased

Sources of funds - cont.



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Sources of funds - cont.

- From IFAD9: gap in funding of target POLG, sovereign borrowing filled the gap
  - Only ordinary term-loans can repay sovereign borrowing without incurring losses
  - Concessional partner loans introduced in 2017: more favourable lending terms but unlikely to provide sizeable and predictable funding stream
  - For IFAD12, Management considers issuing bonds on international capital markets. High credit rating is a <u>must</u>

Allocation of resources - PBAS

- Current PBAS improved transparency of resource allocation
- But PBAS constrains IFAD's ability to increase ordinary lending relative to other types of lending
- In case of a large increase in borrowing, only ordinary term interests can cover borrowing costs
- For IFAD12, Management envisages a second window for ordinary loans, to be allocated through a risk-based system.
  - ➢New for IFAD but standard in MDBs that started borrowing from markets early on

IFAD's financial products

- Borrowing countries appreciate IFAD's loans but are aware of broader choices with other DFIs:

  (i) Higher flexibility on loan maturity, grace period, amortization schedule; single currency loans.

  (ii) Broader typology of financial products

- Gaps in current IFAD financial products: (i) scaling-up; (ii) managing the risk of natural disasters and fragility; and (iii) pre-financing of project implementation preparedness

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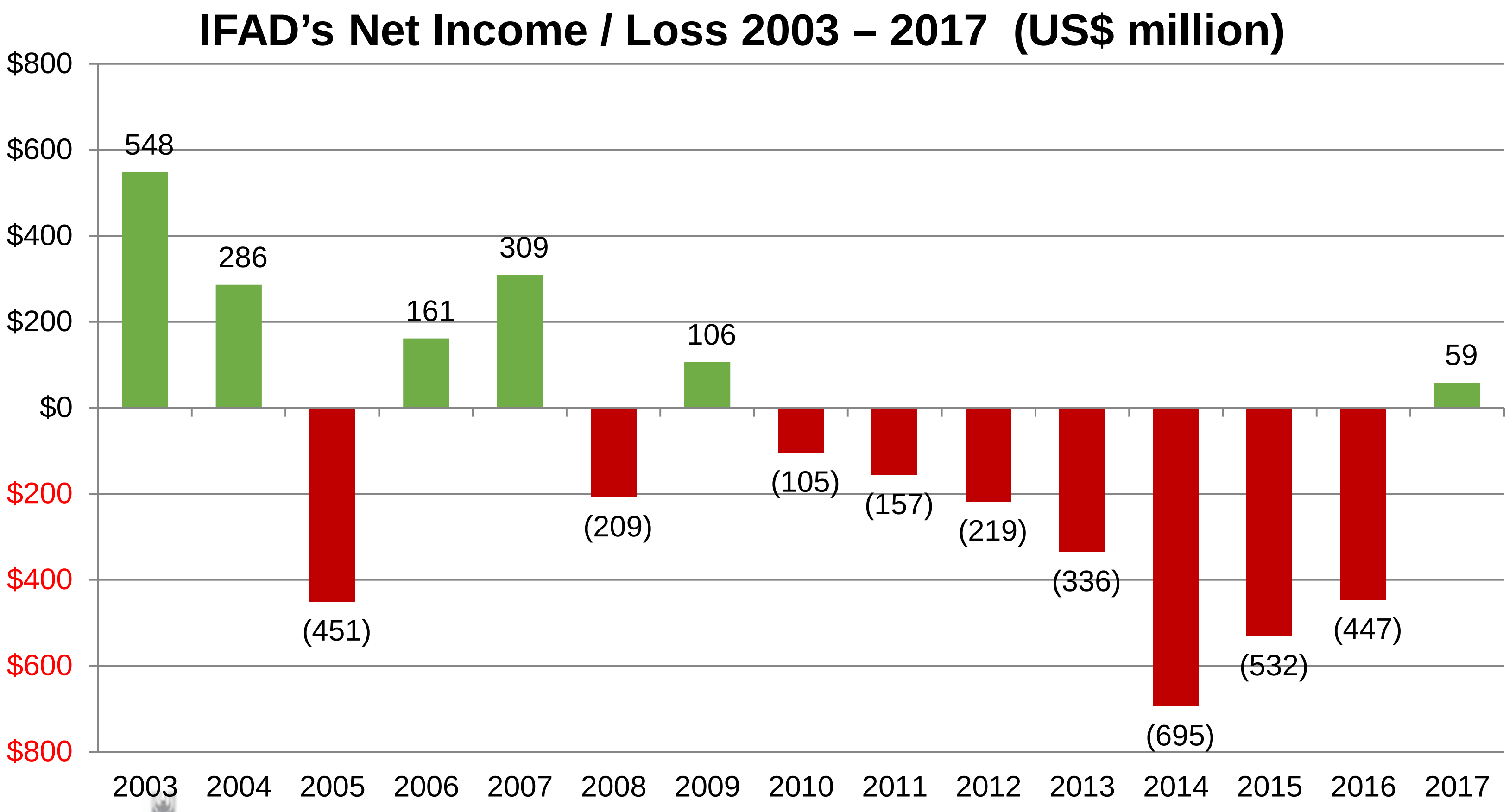
Governance and financial oversight

- Current internal and external oversight system is adequate for a low-risk environment but needs revisiting if borrowing increases substantially
- Key issues:
  - Financial background of members of Governing Bodies
  - Roles and responsibilities for risk management are defined in broad terms in IFAD's policies
  - Limited use of hedging instruments against foreign exchange risks (pledges in non-US$ currency, loan portfolio mostly in SDR)

Financial sustainability

- IFAD has incurred considerable financial losses in the past decade



Financial sustainability – cont.

Key factors

- Low loan portfolio yield: large majority of loans are highly concessional
- IFAD's operating expense ratios are higher than in comparator DFIs: (i) lack of economies of scale and (ii) projects in areas that are costly to serve
- Losses from currency exchange (SDR vs. US$)
- Arrangements for DSF compensation cause uncertainty: "pay as you go" over a 40-year period, not legally binding
  - ➢May be detrimental to credit rating

Conclusions

- Main features of IFAD's financial architecture require reform

➢ Leveraging is low: inefficient use of capital

➢ Single lending PBAS window not compatible with anticipated increase in borrowing

➢ Financial products are not diversified and choice of terms is narrow

➢ Current internal and external financial oversight system not fit for additional financial risks

➢ Far away from cost recovery

Key Recommendations

1. **Improve financial sustainability**

- DSF: introduce pre-payment mechanism
- Raise revenue from loan portfolio
- Measures that improve cost-effectiveness

2. Broader options for financial products

- More flexible options for grace period, maturity, currency
- New financial products for: (i) scaling up; (ii) address natural disasters or fragility; and (iii) pre-financing project implementation preparedness

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Key Recommendations – cont.

3. Establish separate lending window for on-lending at ordinary terms, based on creditworthiness

4. Preparatory work for potential access to capital markets

- High rating is essential. Need to improve financial sustainability and address uncertainty linked to DSF compensation

5 Hedging instruments to manage foreign exchange risks

6. Enhance financial governance

- Extending ToRs of AC and minimum qualifications for membership
- More detailed guidelines for asset & liability and risk management