Investing in rural people

**Evaluation Committee**
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# Review of the implementation of Management's response to the 2018 corporate-level evaluation of IFAD's financial architecture

## Response of IFAD Management

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**FOR: REVIEW**

**Action**: The Evaluation Committee is invited to review the document contained herein.

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# Response of IFAD Management to the review of the implementation of Management's response to the 2018 corporate-level evaluation of IFAD's financial architecture

## I. Introduction

1. Management welcomes the opportunity for further dialogue offered by the review of the implementation of the 2018 corporate-level evaluation of IFAD's financial architecture. In particular, Management appreciates the acknowledgement of the work undertaken since 2018, which has led IFAD to evolve as a development finance institution. The report also acknowledges the achievement of two very strong AA+ ratings from the Standard & Poor's and Fitch rating agencies, which allows IFAD to better leverage its balance sheet.

2. Management generally concurs with the findings and next steps presented in the review, while maintaining a different position on the key issue of financial sustainability. Management also notes the insights of the Independent Office of Evaluation of IFAD (IOE) on the next steps, which overlap in part with actions already under way. On the other hand, in charting the way forward to cover operating expenses and increase the choice of loan options, it will be important to consider the applicability of the options available to IFAD, given its nature as a concessional replenishment fund. Furthermore, it will be key to consider how the insights offered in the review fit with IFAD's mission, as defined in the policies and replenishment resolutions agreed upon with Members States. The importance of remaining within rating agency expectations is another key consideration.

## II. Considerations relating to the main findings

3. **Management concurs with IOE on the importance of ensuring IFAD's financial sustainability** to enable it both to fulfil its mission and to meet the development needs of its target group. However, **financial sustainability should be measured according to IFAD's specific mandate and business model.** IFAD is a replenishment fund, providing mostly concessional financing, including grants, and it serves the most marginalized and food-insecure rural poor. The following paragraphs provide important considerations in this regard.

4. **First, the "operating losses" highlighted in the review are in line with IFAD's business model.** They derive from the accounting treatment of grants as an expense upon disbursement and the recognition of replenishment contributions as equity, as opposed to revenue, as a result of which such contributions do not appear in IFAD's income statement. IFAD's accounting losses, in accordance with International Financial Reporting Standards, are well known to Management, the Audit Committee and the Executive Board.[1] Other concessional replenishment-funded organizations, such as the International Development Association (IDA) within the World Bank Group, also incur operating or accounting losses due to the nature of this business model. IDA's adjusted income statement shows that over the past five years it has had approximately US$11 billion in operating losses. These are mainly due to over US$16 billion in operating expenses.

5. **Second, Member State contributions are the backbone of concessional replenishment funds such as IFAD** and IDA and are an integral part of their unique business model and financial architecture. For example, part of IDA's operating losses over the past five years were funded by Member State contributions (similarly to IFAD). However, unlike IFAD, IDA also benefited from

[1] As per EB 2023/138/R.17, the 2022 total comprehensive loss on the IFAD-only statement of comprehensive income amounts to US$699.2 million.

approximately US$1.5 billion in contributions from affiliated organizations (the International Bank for Reconstruction and Development, the International Finance Corporation and other trust funds). If IFAD were to follow a similar approach, considering the encashment of contributions over the past 10 years, IFAD would net an average US$89 million surplus per year.

6. **Therefore, IFAD will remain sustainable based on strong Member State support**, as evidenced by the continued replenishments of IFAD’s resources since inception. In line with its mandate and business model, IFAD’s financial sustainability relies on the growth of capital (or Members’ support) over time, and not on the operating results of the institution as reflected in its profit and loss statement. Considering only the latter would imply adopting merely an accounting perspective. This view is shared by the Multilateral Organization Performance Assessment Network and credit rating agencies.

7. **In line with the review findings, Management is committed to undertaking an in-depth review of IFAD’s lending terms** aimed at considering all possible trade-offs between sustainability and concessionality, while maintaining a competitive advantage over other development finance institutions. Current policy limitations do not allow for IFAD to increase its revenue base by increasing interest rates or the volume of ordinary term lending, as this would pose risks of mission drift for IFAD. However, Management agrees that if IFAD’s revenues were higher, a larger portion of replenishment contributions could be used to finance grants rather than to cover the Fund’s operating expenses.

8. **In addition, and in line with the review findings, IFAD is currently in the process of assessing its financial strategy to 2030 and beyond,** which includes a review of the optimal debt-to-equity ratio. The report calls for IFAD to increase its leverage limit beyond the current 50 per cent, as it is viewed as overly conservative compared to peers. Management is committed to incorporating specific and plausible recommendations from the recent report by an expert panel convened by the G20 on the multilateral development banks’ (MDBs’) capital adequacy frameworks.[2] However, it is not entirely accurate to compare IFAD’s leverage capacity with those of MDBs, considering the key differences in lending portfolios and callable capital, which are key variables for leverage.

9. **Finally, the comparison of leverage ratios between IDA and IFAD should be placed in context.** If the leverage ratio is the one used in Moody’s methodology, which refers to assets-to-equity instead of debt-to-equity,[3] IFAD’s leverage ratio (as per Moody’s) is estimated at around 1:1, similar to IDA’s, as mentioned in the report. However, if leverage is expressed as debt-to-equity, IFAD’s current leverage remains at around 30 per cent, while it is estimated that IDA’s is below 20 per cent. This partially reflects the higher use of borrowing by IFAD to support its mandate compared to IDA.

# III. Management’s perspective on the next steps

10. Management has carefully reviewed IOE’s findings and insights on the way forward, which provide valuable ideas for dialogue, and appreciates their overall direction. However, there are some important considerations that Management would like to put forward, as detailed below.

11. **Coverage of IFAD’s operating expenses.** Management concurs with some of the points raised in relation to operating expenses, but would like to draw attention to the following limitations:

[2] Boosting MDBs’ investing capacity. (2022). An Independent Review of Multilateral Development Banks’ Capital Adequacy Frameworks. https://cdn.gihub.org/umbraco/media/5094/caf-review-report.pdf.
[3] According to Moody’s methodology for MDBs, a primary measure of capital adequacy is the leverage ratio, calculated as development-related assets and liquid assets rated A3 or lower divided by usable equity.

(i) As mentioned above, Management is reviewing its financial strategy to 2030 and beyond. It is, however, important to note that IFAD's business model and nature as a concessional replenishment fund do not allow for a drastic increase in IFAD's leverage capacity.

(ii) Management agrees that raising the volume of ordinary term loans could help the Fund increase its revenue base. However this option has limited applicability, given IFAD's capital adequacy limits (i.e. debt-to-equity ratio and average rating of the loan portfolio) and the replenishment resolutions agreed with Members States.

(iii) The report mentions that IFAD would need to raise interest rates by 2.20 per cent for it to cover its operating expenses, but it also acknowledges that such an increase is not feasible and recommends that IFAD and its Members discuss feasible fee/rate increases. In the update of IFAD's ordinary loans pricing of 2023,[4] Management introduced the concept of a funding cost-pass-through mechanism to pass on the cost of funding to borrowers when pricing ordinary loans, thus ensuring financial sustainability. This policy was approved by the Executive Board in May 2023. Notwithstanding the above progress, Management is committed to undertaking an in-depth review of IFAD's lending terms, aimed at considering all possible trade-offs between sustainability and concessionality.

12. **Provide borrowers a wider choice of loan options.** Management concurs with some of the points raised, but highlights the following caveats:

(i) While Management agrees on the theoretical benefits of local currency lending, further analysis is required to determine its appropriateness for IFAD and its potential inclusion in IFAD's nascent private sector strategy. Offering local currency loans is an option included in the non-sovereign private sector operations framework; however, IFAD is taking a prudent and gradual approach to building private sector activities.

(ii) As acknowledged in the review, part of IFAD's efforts in addressing the original 2018 recommendations included the revision of the Fund's financing terms, which now allow for greater flexibility to meet borrower needs. IFAD has provided numerous additions to its lending term offers.[5] Management takes note of the suggestion to further assess the possibility of introducing a fixed-rate loan as an additional lending product and will assess this option within the overall review of lending terms.

13. **Managing available funds to service concessional loan disbursement requests should be an operational standard.** Management concurs with this approach. The disbursement planning process in IFAD is now closely linked with the Fund's financial planning efforts. The resources available for commitment process is carried out in consultation with the Financial Operations Department, the Programme Management Department and the Executive Management Committee to ensure IFAD's financial sustainability in the short and medium terms. The financial scenarios presented to the replenishment consultations also adhere to IFAD's enhanced financial policy framework, which, as noted in the 2018 corporate-level evaluation, includes the Debt Sustainability Framework reform and the introduction of the sustainable replenishment baseline concept, the replacement of IFAD's old liquidity policy, the introduction of capital management as a key pillar of long-term financial sustainability and a revamped asset and liability management framework to limit capital consumption.

14. **Gradually increase private sector activities, without competing with existing impact investors.** Management concurs with this approach. The 2019–

[4] EB 2023/138/R.7.
[5] See for example: EB 2018/125/R.45/Rev.1, EB 2020/130/R.34, EB 2021/134/R.50, and EB 2021/132/R.10/Rev.1.

2024 private sector strategy emphasizes the gradual approach and the Private Sector Financing Programme (PSFP) was set up to expand IFAD's direct investment to the private sector, using such an approach. As reported in the Business Model and Financial Framework for the Thirteenth Replenishment of IFAD's Resources (IFAD13),[6] to date the PSFP has already invested in six non-sovereign operations that are promising leverage and results. In addition to an investment in the Agribusiness Capital Fund, IFAD's Private Sector Trust Fund has invested US$25.5 million to six non-sovereign operations through the PSFP, with expected cofinancing of US$140.7 million. These investments are expected to benefit 403,000 people directly and a further 1.4 million people indirectly, of whom 60 per cent are expected to be women and 35 per cent youth. These investments are all in line with the concept of additionality, which is a key criterion for screening and deciding on all IFAD private sector investments. This criterion requires IFAD to show and document its added value (which could be financial or non-financial) compared with existing market sources in order to justify a private sector investment. This prevents IFAD from crowding out existing investors.

15. **Align practices for accessing international capital markets with those of other international financial institutions.** Management concurs with the suggested approach. The possibility of further assessing IFAD's evolution as a borrower with Member States is reflected in the IFAD13 documents. Specifically, Management has committed to continue engaging with Members on the opportunity to identify institutional investors in public, highly liquid local capital markets. This will allow IFAD to continue offering highly competitive financing terms to eligible borrowers, broaden its investor base and increase private sector resource mobilization in support of its core mission. IFAD's evolution as a borrower has been very gradual, as agreed with Member States and rating agencies. IFAD will continue to adopt a gradual approach to leveraging and will liaise with Member States at every step of the process.

[6] IFAD13/2/R.2.