



IFAD
INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT
Governing Council – Twenty-Fourth Session

Rome, 20-21 February 2001

FINANCING FROM NON-DONOR RESOURCES

I. INTRODUCTION

1. In line with paragraph B(vii) of the IFAD V Plan of Action (2000-2002) urging the Fund to “explore the scope for increasing the financing available from non-donor resources”, the Executive Board, at its Seventieth Session in September 2000, was requested to review a concept paper on “Market-Based Project Cofinancing” (EB 2000/70/R.10).
2. The Executive Board at its Seventieth Session expressed appreciation to IFAD’s Secretariat for presenting an innovative mechanism on market-based project cofinancing and requested additional information on this proposal.
3. The Board also recognized that while IFAD actively sought to enable the rural poor to increase their agricultural and/or rural productivity, the Fund could further enhance economic empowerment by catalysing support to relevant economic operators.
4. In line with IFAD’s role as a catalyst in rural poverty eradication, referred to in “Partnerships for Eradicating Rural Poverty: Report of the Consultation to Review the Adequacy of the Resources Available to IFAD, 2000-2002” (GC 24/L.3, paragraph 12), and recognizing that “[...] linkages to markets are crucial to successful project outcomes [...]” (ibid., paragraph 45), IFAD has investigated the possibility of mobilizing additional financial resources above and beyond its own scarce resources. Such additional resources will allow for the promotion of activities providing the link that is often missing between the poor and the less poor.
5. This document presents the results of these investigations and, in particular, outlines a proposed scheme for complementing IFAD’s financing of projects that was endorsed by the Executive Board at its Seventy-First Session. The Governing Council is invited to adopt the annexed draft resolution at its Twenty-Fourth Session in February 2001.



II. THE PROPOSED SCHEME

Highlights

6. Under the proposed scheme, an IFAD project will be complemented by additional activities that will be financed by facilitating the recipient country's access to private capital.
7. It is suggested that the following steps be pursued:
 - (a) additional activities, aimed at the development of relevant economic opportunities (within an extended IFAD project area), will be identified by IFAD in close consultation with the recipient country.
 - (b) On the basis of the estimated additional financing required to carry out these activities, IFAD will consult with investment banks/capital market investors on the pricing of these resources.
 - (c) Loan negotiations concerning this additional credit line will take place with the recipient country.
 - (d) Approval for each concrete proposal will be sought from the Executive Board, which will review its technical and financial soundness. This proposal will include a detailed description of the applicable financial mechanism (described below).

Financial Mechanism

8. For each project qualifying for the scheme, a trust fund will be established:
 - within IFAD as legally separate from IFAD's own resources;
 - to receive resources – provided by the investment bank/capital market investors – specifically earmarked for the sole purpose of financing specified activities in a given country.
9. A trust fund agreement will be signed between IFAD and the provider of these resources setting out the obligations of either party to the agreement. It will therefore address in detail:
 - all risk categories IFAD might be faced with;
 - the possible remedies to be taken should these occur;
 - the likelihood of such risks occurring; and
 - the sequence of events that will take place in the unlikely event of their occurrence.
10. A loan agreement will be signed between the recipient country and IFAD allowing the sovereign country to borrow the resources in trust. The sovereign borrower will access these resources at the cost of capital (see section on “Pricing”), i.e., upon conditions that differ from those IFAD applies to this particular borrower under its own loans.
11. In addition, the sovereign borrower will be charged a margin to compensate for IFAD's role both in administering resources that are not its own and in designing the activities to be financed (see section on “Costing” below).



12. To ensure that the mechanism adopted is the most effective possible, these additional resources should be drawn down according to a pre-determined schedule for the implementation of the aforementioned activities. The cofinancier will transfer resources to the trust only when the borrower calls for these resources according to the schedule specified earlier. Such resources are therefore directly made available to the borrower. These resources, since they will be channelled through a separate trust fund, will not be “owned” by IFAD, but only administered by IFAD. Hence, they will not technically go through IFAD’s accounts, but only through the (separate) books of the trust fund.

13. As administrator of these additional funds, IFAD will collect principal and interest due on the cofinanced tranche. These reflows are only channelled through the trust fund for immediate distribution to the investment bank/capital market investors, pursuant to the trust fund agreement.

Role of investment banks/capital markets investors

14. The role of investment banks/capital markets investors will be strictly limited to the provision of financial resources and will not involve any participation in the design of activities. The sole concern of investors is the credit quality and payment history of the recipient.

Pricing

15. Investors will charge a spread that will compensate them for the perceived risk. The spreads on the cofinancing tranche will vary with both the credit quality inherent to the countries considered and their default and payment history with IFAD.

16. The sovereign borrower’s repayment record with IFAD is typically superior to the repayment record of the same borrower with capital markets. IFAD’s loan administration and handling function will therefore allow the sovereign borrower to benefit from a reduction in the cost of capital. This does not reflect any additional guarantee provided by IFAD but rather the trust that is placed in IFAD to recover the private capital resources in the same manner as it recovers its own resources from a given borrower.

17. As one illustration of the proposed scheme, Executive Board document 2000/70/R.10 referred to potential cofinancing sought for the recently approved “Rural Development Project for Rubber-Producing Regions of Mexico”. This example considered the identification of activities requiring additional non-IFAD resources of USD 5 million over an eight-year period. It was considered that the implementation of these activities would enhance the impact of IFAD’s underlying project on its target population.

18. Mexico as a sovereign borrower can currently¹ access international capital markets at a margin of 2.72 percentage points over USD LIBOR^{2 3} on its own. Taking advantage of IFAD’s expected recovery on a loan to Mexico being greater than market-based recovery assumptions for this borrower, the cofinanced tranche could therefore be priced at a margin of 2 percentage points over USD LIBOR⁴. Through this mechanism, Mexico would have benefited from a discount of more than 26% on the cofinanced tranche.

¹ As of May 2000.

² *London Interbank Offered Rate* is the rate of interest that major international banks in London charge each other for borrowings and serves as a reference rate.

³ USD LIBOR+272 basis points per year for a seven-year loan in the range of USD 5 million.

⁴ USD LIBOR+200 basis points.



19. The margin of 2 percentage points over and above USD LIBOR per year is the margin that the private investors would earn on the considered loan over the estimated eight-year period. This margin reflects the perceived (credit- and sovereign-) risk involved in lending to Mexico through the trust fund established with IFAD.

20. Some legal fees related to up the necessary documentation (see section below) for the establishment of the trust agreement will be charged by outside independent lawyers. Such fees will decrease with the repeated use of the scheme, as some of the documentation will be increasingly standardized.

21. In addition, the arranging investment bank will expect to receive an arrangement fee, which will be benchmarked on similar fees charged to the sovereign borrower for transactions it undertakes in the capital markets.

Risks

22. As mentioned in paragraph 7, in every instance, the Executive Board will be presented with a proposal concerning the planned additional activities and the financing thereof through non-IFAD resources, i.e., by promoting the recipient country's access to private capital. This proposal will detail assurances contained in the trust fund agreement to allow the Executive Board to see that risk categories inherent to that particular transaction have been properly addressed by IFAD when the trust fund agreement is signed.

23. The private-market financial resources are made available to the trust on a non-recourse basis, (for immediate pass-through on-lending to the sovereign borrower, see paragraph 12 above). In effect, in the unlikely event of the borrower not making a payment to the trust, IFAD will not be obligated to make a distribution under the trust. This means that through this mechanism, investment bank/capital market investors are taking the repayment risk associated with that particular sovereign borrower.

24. In the unlikely event of default, i.e., non-repayment of the sovereign borrower's obligation to the trust, the following events will take place:

- (a) IFAD as the trustee will be required to notify the investment bank/capital market investors of the default (as defined by a number of days of non-payment of dues to the trust as specified in the agreement establishing the trust).
- (b) IFAD, in conjunction with the investment bank/capital market investors, will decide on the course of action to recover and/or reschedule the outstanding amounts from the sovereign borrower.
- (c) IFAD will approach the sovereign borrower with a proposal to carry out the above-mentioned action plan.
- (d) If the investment bank/capital market investors were not satisfied with IFAD's role as trustee in carrying out the above-mentioned action plan, IFAD would allow them to pursue the debt themselves.
- (e) The investment bank/capital market investors *will not* have any recourse against IFAD's Executive Board (or its member countries) to urge IFAD to pursue the re-collection of outstanding amounts.



Guarantees

25. It needs to be underlined that the discount achieved in the above-mentioned example (see paragraph 18) is *solely* achieved through IFAD's benefiting from a superior recovery rate on the sovereign country's debt. It *does not* involve the provision of any partial credit- or risk-guarantee to reduce the investors' exposure to risks they (and IFAD for that matter) cannot control.

26. IFAD will not guarantee either principal or interest repayments to the investors. Hence, in the unlikely event of default, the investors can call no guarantee. The spread charged by the investors (as seen in paragraph 18) does compensate for the risk they perceive to be attached to such an operation. In fact, in the earlier-mentioned example, had IFAD provided a guarantee, the achieved discount would have been higher and maturities would probably have been extended beyond the assumed eight-year period.

27. However, the provision of additional guarantees through external agencies and institutions could be considered to further improve the conditions offered to the borrower (see paragraph 39 below).

Costing

28. IFAD's role in catalysing a borrower's access to capital market resources for the implementation of activities that will further enhance the impact of an IFAD-financed project will require spending some internal resources. Such resources will be necessary for:

- the design, appraisal and implementation of the activities referred to above; and
- the management of the additional flows generated in terms of both disbursements and collecting payments and passing them on to investors through the trust.

29. The scarcity of IFAD's own resources will lead IFAD to seek full cost recovery for its involvement in promoting access to the private credit line under consideration and pass on additional costs to the borrower.

30. IFAD will therefore have to consider charging two types of fees to the borrower, the amount of which will be determined on a case-by-case basis :

- An upfront, one-off arrangement fee, which will cover all expenses incurred in the design, appraisal and implementation of the activities under consideration. It is suggested here to charge between USD 10 000 and USD 30 000, depending on the estimated costs.
- An annual administration fee that will cover IFAD's handling of the cofinanced loan as if it were its own. It is suggested here to charge between USD 5 000 and USD 10 000 per annum depending on the estimated costs.

31. As mentioned in EB document 2000/70/R.10, beneficiaries of the market-based project cofinancing credit line can be "[...] small and medium-size private-sector enterprises and entrepreneurs in order to bridge gaps normally present in small farmers' agricultural and non-agricultural productive chains". The borrower can thus price access to these resources in a manner that will also allow it to recover the earlier-mentioned costs and therefore avoid market distortion.



Documentation

32. The relationship between a participating financial institution and the sovereign borrower is indirect.
33. Therefore, mobilizing market cofinancing will require a number of agreements to be signed:
- A cofinancing loan agreement between IFAD and the sovereign borrower allowing it to access market resources through a trust fund to be established with IFAD for each transaction.
 - A trust fund agreement between the participating investment bank/capital market investors and IFAD on the modalities governing the establishment of the specific trust fund referred to above. As mentioned in paragraph 9, this agreement will set out the obligations of either party to the agreement and will therefore address in detail all risk categories IFAD might be faced with and the remedies to be taken should these occur.

III. EXPECTED BENEFITS

34. Mobilizing cofinancing from markets will allow IFAD to play its catalyst role more effectively. By leveraging its own resources and building on its skills, IFAD will be able to provide sovereign borrowers with additional market resources to secure debt financing with maturities and terms that are more suitable to development projects. The resources thus mobilized will directly contribute towards the promotion of economic opportunities for the rural poor.

IV. APPLICABILITY

35. EB document 2000/70/R.10 recalled the focus for allocating IFAD's resources towards the rural poor. The currently applicable regional distribution of the Fund's lending programme was determined at the September 1999 Session of the Executive Board. In EB document 99/67/R.10, allocations to Africa account for 36.77% of total commitments; those to Asia and the Pacific, 31.01%; to Latin America and the Caribbean, 17.03%; and to the Middle East and North Africa, 15.09%.

36. This regional distribution of IFAD's own resources will remain at these levels and *will not be* affected by the mobilization of additional resources through the proposed mechanism.

37. All of IFAD's recipient countries will eventually have the potential to benefit from market cofinancing. However, given the innovative nature of the planned facility and the fact that IFAD does not extend guarantees of any sort (neither partial risk nor credit guarantees), this scheme will initially be limited to creditworthy countries in IFAD's ordinary and intermediate-term categories.

38. Once this programme has been operational for some time it may be possible to:

- include some countries in the highly concessional category; and
- further enhance the conditions (pricing and tenor) of the cofinanced loans offered to ordinary and intermediate-term borrowers.



39. In order to achieve this, IFAD could seek to improve the perceived overall risk return of the activities to be financed through the markets by introducing some guarantees in the transaction's structure. Initial discussions with the World Bank's Multilateral Investment Guarantee Agency (MIGA) show that credit enhancement could be provided by this agency to cover some of the risks associated with both the country and the activities under consideration for the cofinanced credit line.

V. RELEVANT EXPERIENCE IN OTHER INSTITUTIONS

40. Mobilizing resources from private markets has become a key component of the Asian Development Bank's (AsDB) operational strategy. AsDB's "Complementary Financing Scheme" (CFS)⁵ is a participation mechanism under which the Bank in addition to its own loan, makes a complementary loan on market-based terms to the sovereign borrower. The CFS is entirely funded by participants from the markets. AsDB is the lender-of-record as the complementary loan is made in its name; however, the cofinanciers will have no credit recourse to AsDB for debt service. Cofinanciers providing CFS loans also benefit from AsDB's appraisal, supervision, project implementation and loan administration services. The Bank serves as a channel for disbursements and debt service payments. As of December 1998, 33 CFS loans had been arranged for 31 projects in eight countries for a total of USD 820 million.

VI. RECOMMENDATIONS

41. The Governing Council is invited to consider this proposal and to adopt the annexed draft resolution.

⁵ Source: Office of Co-financing Operations, Asian Development Bank, "Commercial Co-financing"(1999).



**DRAFT RESOLUTION ON INCREASING THE FINANCING AVAILABLE
FROM NON-DONOR RESOURCES**

Resolution _____/XXIV

Increasing the Financing Available from Non-Donor Resources

The Governing Council of IFAD,

Recalling document GC 24/L.3: “Partnerships for Eradicating Rural Poverty: Report of the Consultation to Review the Adequacy of the Resources Available to IFAD, 2000-2002” and the IFAD V Plan of Action (2000-2002) annexed thereto;

Noting Recommendation (vii) of the said IFAD V Plan of Action (2000-2002), which called on the Secretariat to “explore the scope for increasing the financing available from non-donor resources” so as to produce an “agreed approach to possible new ways of increasing non-donor finance”;

Taking into consideration document GC 24/L.10 on Financing from Non-Donor Resources;

Decides to:

1. Request the Secretariat to continue to explore the scope for increasing the financing available from non-donor resources, including market-based mechanisms, and to submit any proposals that may result from such exploration to the Executive Board for approval.
2. Approve the proposed framework on market-based cofinancing of IFAD-financed projects and programmes contained in document GC 24/L.10 and to authorize the Executive Board to consider and approve each specific proposal for such cofinancing, and the arrangements therefor, on a case-by-case basis. The Executive Board is further requested to review on a regular basis the framework for such cofinancing as approved by the Governing Council herein.