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Financial strategy for IFAD11 and beyond

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Abbreviations and Acronyms

| | |
|------|---------------------------------------|
| AfDF | African Development Fund |
| CPL | concessional partner loan |
| DSF | Debt Sustainability Framework |
| IDA | International Development Association |
| IFI | international financial institution |
| MDB | multilateral development bank |
| MLR | minimum liquidity requirement |
| PBAS | performance-based allocation system |
| PoLG | programme of loans and grants |
| SBF | Sovereign Borrowing Framework |
| SCF | sustainable cash flow |
| SDR | special drawing right |
| UMIC | upper-middle-income country |

Executive summary

1. In recognition of the globally challenging financial situation and the need to scale up support to Member States, IFAD introduced borrowing as an additional funding source in the IFAD9 period. This enabled it to fund a larger programme of loans and grants (PoLG) than would have been possible using resources from contributions only.
2. Building on that experience to ensure a comprehensive and strategic approach to leveraging its resources, IFAD developed a borrowing framework to guide future loan negotiations. The Sovereign Borrowing Framework (SBF) was developed in 2014–2015 with guidance from the Audit Committee; and it was approved by the Executive Board in April 2015. The SBF establishes the main borrowing parameters, including the financial conditions. In line with peer international financial institutions (IFIs), it introduces financial ratios alongside the existing Liquidity Policy to guide the Fund's financial management.
3. Compared to other IFIs, IFAD's proposed approach to borrowing is very prudent and is intended to be implemented at a conservative pace over the medium-to-long term.
4. The next step is to fully integrate borrowing into IFAD's financial framework and planning, to no longer be confronted with funding gaps for an agreed PoLG level, which have to be bridged with ad hoc borrowing arrangements. It will also allow IFAD to mitigate the issue of timely availability and viability of borrowing.
5. Therefore, an approach based on leveraging available resources could be introduced to strengthen the link between contributions and the PoLG, leaving no doubts as to whether the resources available are sufficient to fund the desired programme level.
6. Under this approach, Member contributions will remain the bedrock of IFAD's capital and financial commitment capacity; and they would then be used as a basis for maintaining and/or prudently expanding IFAD's commitment capacity.
7. Such an approach would build on what IFAD has already achieved through the SBF, since it would provide a rule-based methodology for embedding borrowed resources in a stable manner into IFAD's capital structure – irrespective of whether the borrowing comes from sovereign entities or from the capital markets.
8. Should the decision be taken to pursue the proposed leveraging strategy, IFAD's risk management framework would be further strengthened to mitigate the risks arising from leverage. The existing framework, contained in the SBF, would be complemented with an additional set of policy measures and financial ratio requirements, with the aim of significantly strengthening IFAD's risk management.
9. IFAD could diversify its resource base by adopting a number of leveraging options within an enhanced financial strategy based on asset liability management considerations.
10. In terms of resource allocation, a review of the performance-based allocation system (PBAS) formula and procedures is currently ongoing; and the results of this will be submitted for Executive Board approval in September 2017. While no further changes to the PBAS are envisaged for the foreseeable future, the issue may be further revisited as and when the proposed leverage strategy is implemented.
11. With support from the Membership, Management could start rolling out the measures gradually, taking account of issues such as the findings of a peer review study to assess the Fund's degree of preparation for capital market borrowing, and of the corporate-level evaluation on IFAD's financial architecture, which the Independent Office of Evaluation of IFAD expects to deliver in September 2018. The credit rating process could then be launched in 2019, with IFAD's first bond issue –

to the extent needed – by the end of the Eleventh Replenishment of IFAD's Resources (IFAD11) or during IFAD12.

Financial strategy for IFAD11 and beyond

I. Recent changes in IFAD's financial structure

A. Introduction of borrowing as a funding source

1. Since its inception, IFAD has been funded by core contributions from its Member States in the form of grant money, supplemented by internal resources, consisting mainly of loan reflows and investment income. The Fund uses its financial resources to fund a programme of loans and grants (PoLG) and to cover its administrative expenses.
2. During the Ninth Replenishment of IFAD's Resources (IFAD9), in recognition of the globally challenging financial situation, IFAD introduced borrowing as an additional funding source, to make better use of Member contributions and fund part of its PoLG.
3. In September 2010 IFAD established the Spanish Food Security Cofinancing Facility Trust Fund (Spanish Trust Fund). This consists of a loan from the Government of Spain in the amount of EUR 285.5 million and a grant of EUR 14.5 million provided to lower the average interest rate that the Government of Spain charges to the Spanish Trust Fund. This loan was instrumental in enabling IFAD to gather initial experience in managing borrowed resources.
4. The Spanish Trust Fund's assets and liabilities are ring-fenced and kept separate from IFAD accounts; and they are used only for the purposes of the Spanish Trust Fund. The Spanish Trust Fund is reported on in IFAD's consolidated financial statements.
5. The first borrowing agreement that IFAD entered into directly involved a loan from KfW Development Bank. In September 2014, the Executive Board approved the signing of a Framework Agreement with KfW Development Bank for up to EUR 400 million, of which EUR 300 million, was used to fund projects approved in the IFAD9 triennium (2012-2015). An amount of EUR 100 million was left over and then used in the IFAD10 period.
6. In addition, in 2012 an Adaptation for Smallholder Agriculture Programme (ASAP) Trust Fund was established to contribute to the financing of IFAD9. This was a one-off financing exercise, exclusively for IFAD9, and it was not repeated in the following replenishment. The ASAP Trust Fund was an important milestone for IFAD enabling it to position itself at the forefront of climate adaptation investments alongside other major players.
7. While global financial conditions remained challenging, IFAD recognized that, in line with other IFIs and for the Fund to be able to increase its assistance to rural populations in a stable and predictable manner in the future, borrowing should become a more regular source of complementary financing.
8. To put a comprehensive and strategic approach to borrowing in place, the Executive Board requested that IFAD develop a framework to guide future borrowing negotiations. The Sovereign Borrowing Framework (SBF) was developed in 2014–2015 with guidance from the Audit Committee; and it was approved by the Executive Board in April 2015. The SBF establishes the main parameters under which IFAD can borrow, including the financial conditions; and it defines borrowing limits in terms of balance sheet and liquidity ratios to preserve the Fund's long-term sustainability. This was the first attempt to introduce financial ratios alongside the existing Liquidity Policy to steer the Fund's financial management in line with peer international financial institutions (IFIs).

9. In 2017, IFAD signed a borrowing agreement under the SBF with Agence Française de Développement, which allows IFAD to borrow EUR 200 million over a two-year period.
10. Before the introduction of borrowing as a stable funding source, IFAD's financial sustainability was defined only in relation to core replenishment contributions. As a result, borrowing was not fully captured by resources available for commitment, which only considered the most recently updated projections of contributions and internal resources.

B. Sustainable cash flow approach for determining the programme of loans and grants and inclusion of borrowing

Sustainable cash flow approach

11. As of IFAD9, IFAD introduced the sustainable cash flow (SCF) approach for determining the level of PoLG that the Fund can commit to delivering within a given core contributions replenishment envelope. This approach introduced a new dimension which is critical to IFAD's operations: i.e. the time of materialization of flows. The SCF was introduced in recognition of the fact that, in planning its operations over a given replenishment period, paramount consideration must be given to the long-term impact of decisions taken today on IFAD's liquidity position and financial sustainability in the future. It was recognized that IFAD's committable PoLG in every replenishment period should be assessed at a level that does not endanger the future of the Fund.
12. A given level of PoLG in one replenishment period was therefore defined as "cash flow sustainable", if, by projecting all the cash inflows and outflows resulting from that programme and future programme levels supported by core contributions (assumed flat in real terms), IFAD's liquidity balance never falls below its minimum liquidity requirement (MLR) throughout the projection horizon. The Fund's MLR is defined in IFAD's Liquidity Policy¹ and is set at a level of 60 per cent of annual projected gross disbursements, and potential additional requirements due to liquidity shocks.

Inclusion of borrowing in the SCF approach

13. As noted in section I.A above, borrowing was introduced as a funding source for IFAD's PoLG during the IFAD9 period. Several analyses of the impact on the Fund's finances and future financial structure were made at that stage; and these were further enhanced when determining the constraints set in the SBF. The aim was to ensure that borrowing would enhance IFAD's funding base without putting its financial soundness at risk.
14. To achieve this goal, borrowing was introduced as an allowable funding source under several conditions. Firstly, "borrowed funds can be used to support all onlending by IFAD, at the prevailing terms, provided that the terms of the loan and the cash flow projections for the onlending (based on the demand for and the terms of the loan) satisfy the principles of financial sustainability in isolation (or are "self-funding"). Financial sustainability in isolation requires that cash flow projections for the borrowed funds and their onlending – including related administrative costs, provision charges and cash flows from the onlending (disbursements and repayments), together with any grant support other than IFAD's resources are such that the net cash balance is never negative in the period of borrowing or onlending, whichever comes later."²
15. In addition to borrowing in isolation, analyses are also performed to ensure that the borrowing is not detrimental to IFAD's future projected cash flow. Accordingly, the condition of "sustainability in isolation" must also be respected. This means that the

¹ See: EB 2006/89/R.40.

² EB 2015/114/R.17/Rev.1 Sovereign Borrowing Framework, paragraph 16.

consolidated cash flow projections, including the borrowing facility, and the cash flows related to the operations funded from replenishment contributions, should continue to satisfy the MLR.

16. In addition to cash flow, and in view of IFAD's gradual move towards fully embedding borrowing in its capital structure, certain balance sheet covenants were introduced in the SBF. These should be respected at all times and are forecast before entering into any additional borrowing agreement.
17. Compared to other IFIs, IFAD's proposed approach to borrowing is very prudent, and it is expected to be implemented at a conservative pace. Table 5 in section IV of this document provides a comparison between IFAD's current and projected leverage ratios and those currently prevailing in other IFIs.

C. Single currency lending

18. During IFAD10, the Fund further enhanced its financial structure and risk management by starting to approve loans funded from its own resources, denominated in a single currency (either the euro or the United States dollar) as an alternative to special drawing rights (SDR). IFAD widened the choice of currencies available to its borrowing countries by offering loans in United States dollars and euros. At the same time, this allows the Fund to better match its commitments with its resources and to gradually streamline its currency management. It also allows for a higher-yielding investment strategy while the committed funds are awaiting disbursement.
19. Single currency lending has been a very successful initiative and is forecast to ramp up further. Between February and December 2016, US\$293 million equivalent of single currency loans had been approved, covering 37 per cent of the 2016 PoLG. The level of single currency lending is being closely monitored internally, to ensure that the limits set by Management (currently US\$1.6 billion) are not exceeded.

II. IFAD's unique institutional setup

A. The financial nature of IFAD

20. In recent years, IFAD Management has been drawing attention to the Fund's special institutional nature as both a specialized agency of the United Nations and an IFI. Not many institutions enjoy this dual feature.
21. Although it is called a "Fund", IFAD is different from the "Programmes and Funds" of the United Nations³ such as the United Nations Children's Fund, United Nations Development Programme and others. IFAD has been established as an independent specialized agency and brought into the United Nations sphere through a relationship agreement which provides that: "In its financing operations, the Fund shall exercise its own independent judgement in accordance with the Agreement ...".⁴ In this respect, IFAD is similar to other IFIs, such as the World Bank and the International Monetary Fund, with which it shares key common features pertaining to their membership (multiple member states), role (development and reconstruction, poverty alleviation) and modus operandi (long-term loans and grants).
22. IFIs and multilateral development banks (MDBs) have almost identical definitions, and the two terms are often used interchangeably. Nonetheless the two are not strictly identical. For example the European Investment Bank (EIB) – one of the largest IFIs Globally – does not explicitly list itself as an MDB on its website. As an IFI, many of IFAD's business practices conform to those followed by MDBs, such as taking part in joint initiatives like Heavily Indebted Poor Countries (HIPC) Debt Initiative; and it participates in many MDB working groups like the Chief Risk

³ See www.un.org/en/sections/about-un/funds-programmes-specialized-agencies-and-others/index.html.

⁴ Agreement between the United Nations and the International Fund for Agricultural Development, General Assembly resolution 32/107, article IV.2, www.un.org/en/ga/search/view_doc.asp?symbol=A/RES/32/107.

Officers Forum or the MDBs Controllers' Forum, which demonstrates that IFAD is indeed considered a peer institution by all other MDBs.

23. These considerations are important for ensuring that if IFAD borrows from the capital markets, as further discussed in section IV, it can do so on the cheapest terms possible.
24. In this respect, one of the critical benefits of being a highly rated MDB is the possibility of being attributed a so-called "zero per cent risk weight factor" by the Basel Committee on risk management. For many professional investors, this means that when they buy a bond issued by a highly rated MDB that is also classified as zero per cent risk weight, the bonds in question will receive the most favourable treatment in the any stress test being performed on their portfolio. This usually translates into favourable issuance terms for borrowers. Most IFAD peers enjoy this treatment in the European Union, as can be seen in article 117 of its regulation number 575/2013 on "prudential requirements for credit institutions and investment firms";⁵ and, in the event that IFAD decides to borrow from the capital markets, securing the same treatment would be highly desirable.

B. Further enhancements towards MDB best practices

25. As noted above, over the last two replenishment cycles IFAD has made significant changes to its financial structure and funding mechanism, thereby aligning its financial practices to the standard followed by other MDBs, while also preserving the Fund's unique business model. Additional steps in this direction are under way, to ensure that IFAD has the right toolkit.
26. Two enhancements are crucial for ensuring that IFAD has the necessary level of risk management and asset liability management (ALM) capabilities: firstly, the ability to enter into derivatives transactions directly. In this connection, in 2016 IFAD concluded the negotiations of its first International Swaps and Derivatives Association master agreement with a bank counterparty, for over-the-counter derivatives transactions. Furthermore, IFAD staff are continuously strengthening their capacity by attending ad hoc seminars at major banking institutions. Also, specific derivatives training events have been organized at IFAD headquarters and provided by the World Bank and other IFAD professional counterparts.
27. Secondly, IFAD is working towards implementing structured credit risk monitoring and management on its loan portfolio. In line with best practice, sovereign default probability analyses are used to compute country exposure and strengthen the concentration of risk management. This will also be required by International Financial Reporting Standard 9 (IFRS9), which will become effective as of January 2018, and will apply to IFAD.

III. New financing options

Greater leverage of the resource base

28. In recent years, governments have been more active in advocating that the contribution money donated to the development cause be used more efficiently to mobilize the maximum possible impact within an acceptable risk level. Since 2013, the G20 has encouraged MDBs to "optimize balance sheets, in order to increase lending without substantially aggravating risks or damaging credit ratings".⁶ At its Antalya meeting in November 2015, the G20 developed the Antalya Action Plan to optimize MDB balance sheets.⁷ Among other things, the plan noted that MDBs "may be able to increase their development lending, while maintaining AAA ratings, if

⁵ The full text can be found here: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0575>.

⁶ See: www.g20.utoronto.ca/2015/Multilateral-Development-Banks-Action-Plan-to-Optimize-Balance-Sheets.pdf.

⁷ See: www.oecd.org/g20/summits/antalya/Antalya-Action-Plan.pdf.

shareholders agreed for MDBs to operate with higher leverage and at a marginally increased level of risk".⁸

29. IFAD has already moved in this direction, as described earlier in this paper; and it has started from a very conservative (low leverage) position, by imposing a set of financial ratios that would help keep risk under control. These initial steps were taken in the context of setting up the SBF.
30. Table 1 shows the thresholds defined under the SBF and their values, as at 31 December 2016.

Table 1
Sovereign Borrowing Framework financial ratios as at December 2016

| | <i>Value as of December 2016</i> | <i>Threshold as per SBF</i> |
|------------------------|--------------------------------------|---------------------------------|
| Debt/equity | 3.3% | < 35% |
| Liquidity/assets | 15.9% | > 5% |
| Debt service coverage* | 0.1% | < 50% |

* Ratio of principal and interest to all IFAD lenders in a given year to total yearly loan reflows from IFAD borrowers as per latest audited financial statements.

31. Applying these ratios, IFAD is already facing and successfully managing some of the risks associated with leveraging through debt financing; and the challenge now is to explore how to complement these steps with others that will make IFAD even more capital-management efficient.

IV. Impact of leveraging on IFAD's business model

32. It should be noted that none of the possible changes referred to in this section are either expected or necessary in the short term. The simulations and the scenarios described in this paper are all based on policies and practices currently in place at IFAD.
33. Therefore, the potential need to review some of the policies, as mentioned in this section (minimum liquidity requirement policy, the performance-based allocation system [PBAS], strengthening of internal IT systems, additional human resource requirements), is expected to be met gradually over the medium term, depending on the strategy adopted for IFAD leveraging.
34. This paper assumes that IFAD will continue to operate under the current financial strategy in IFAD11, gradually implementing potential innovations as preparations are completed. Depending on Member support, the approvals required from governing bodies, and progress in internal preparations, some of the initiatives described in this paper could start to be rolled out towards the end of the IFAD11 period. Management could initiate the process for obtaining a credit rating in 2019; and, depending on the outcome, it could launch its first bond issue towards the end of IFAD11 or during the IFAD12.

A. Towards a comprehensive leveraging strategy

35. From a financial point of view, IFAD currently adopts a very simple business model for both funds received and funds allocated: there is a single pot, where financial resources flow in and are then allocated on various financial terms to a pool of beneficiaries determined by a single pre-agreed mechanism, namely the PBAS. In this respect, IFAD is possibly the only IFI that applies the same PBAS mechanism across the entire spectrum of its allocated resources.
36. As explained in detail in the document "Update on IFAD's Engagement with Middle-Income Countries",⁹ the Fund classifies countries according to their borrowing terms, i.e. on whether they access loans on highly concessional, blend or ordinary

⁸ See footnote 6.

⁹ Document EB 2016/117/R.3.

terms. While there is significant overlap between these categories and income-based classifications, the system is not identical to the way other IFIs – e.g. the World Bank and International Development Association (IDA) – classify their borrowers.

37. While IFAD does not group countries by their income levels, it does draw on the World Bank's income classification which groups countries as low-income countries, lower-middle-income countries (LMICs), upper-middle income countries (UMICs), and high-income countries. Table 2 shows the current classification by income level and the corresponding lending terms applied by the World Bank.¹⁰ As can be seen, although the distribution of resources at the World Bank Group broadly reflects countries' income capacity, there can be exceptions. For example, a large number of LMICs access resources on IDA or blend terms, and some UMICs also access the same windows. The same can happen at IFAD, as explained in greater detail in the paper "Enhancing IFAD11 business model to deliver impact at scale" which is also being presented at the second session of the IFAD11 Consultation.

Table 2

World Bank country-income classification and lending terms

| <i>Income level</i> | <i>Count</i> | <i>IDA</i> | <i>Blend</i> | <i>IBRD</i> | <i>N/A</i> |
|-------------------------------|--------------|------------|--------------|-------------|------------|
| Low-income economies | 31 | 29 | 1 | 0 | 1 |
| Lower-middle income economies | 52 | 27 | 13 | 11 | 1 |
| Upper-middle-income economies | 56 | 4 | 4 | 46 | 2 |
| High-income economies | 79 | 0 | 0 | 9 | 70 |
| Total | 218 | 60 | 18 | 66 | 74 |

38. Table 3 shows the proposed allocation of IFAD's resources over the IFAD11 period (2019-2021). For ease of comparison we have kept this as the baseline allocation for all the scenarios presented in this paper.¹¹ Compared to other IFIs, the proportion of IFAD resources that are allocated to highly concessional and grant use is relatively high. This puts pressure on the Fund's financial sustainability and requires periodic replenishments from its Member States. In comparison, out of the total envelope of financial assistance approved by the African Development Bank Group in 2015, 24 per cent was provided on highly concessional terms while 71 per cent was non-concessional.¹²

Table 3

Indicative loan type allocation in IFAD11

| <i>Loan type</i> | <i>% allocation</i> |
|-------------------------------|---------------------|
| Highly concessional and grant | 54 |
| Blend | 16 |
| Ordinary | 30 |
| Total | 100 |

39. A major constraint on maintaining this approach in the future was introduced when the Executive Board approved the SBF. At the time, it was decided that any borrowing arrangement that IFAD entered into would have to be self-funded, which meant that it would not need to be subsidized from replenishment money (see

¹⁰ Income groups are not used by the World Bank in resource allocation decisions. For operational lending categories, economies are divided into IDA, International Bank for Reconstruction and Development (IBRD), and blend countries, based on the World Bank's operational policies. IDA countries are those with low per capita incomes that lack the financial ability to borrow from the IBRD. Blend countries are eligible for IDA loans but are also eligible for IBRD loans because they are financially creditworthy (<https://datahelpdesk.worldbank.org/knowledgebase/articles/378834-how-does-the-world-bank-classify-countries>).

¹¹ Annex I presents the full set of assumptions underlying the scenarios presented in the document.

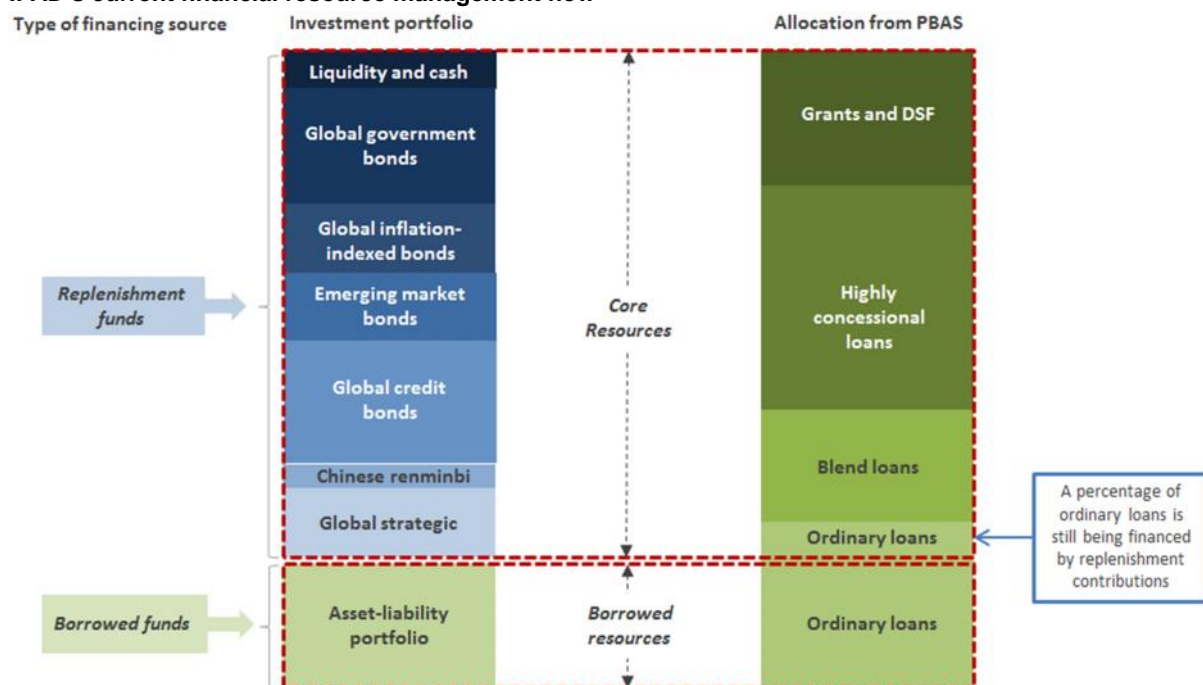
¹² Source: African Development Bank Group: Annual Report 2015, page 38: www.afdb.org/fileadmin/uploads/afdb/Documents/Generic-Documents/Annual_Report_2015_EN_-_Full.pdf.

“sustainability in isolation”, as explained in paragraph 14 above). This led IFAD to create a dedicated investment portfolio – the asset liability portfolio (ALP) – funded by borrowed funds pending disbursement to IFAD projects, thereby effectively segregating any borrowed resources from donor-contributed money. The ALP is managed with a specific asset liability matching strategy, aimed at obtaining a return as close as possible to the borrowing cost, and – in anticipation of IFAD’s implementing derivatives – it is kept in the same currency as the borrowed funds to avoid foreign exchange risks.

40. Nonetheless, the PBAS continues to govern the way both contributions and borrowed funds are allocated; the exception being that Management decided that borrowed money would only be allocated to countries on ordinary terms, as shown in chart 1, to preserve sustainability. Until IFAD10, and also in IFAD11 (provided the Fund achieves a successful outcome), this constraint will not pose problems, because the allocation prescribed by the PBAS to ordinary loans is larger than the amounts IFAD plans to borrow.

Chart 1

IFAD’s current financial resource management flow



41. The next step in enhancing the financial strategy is to fully integrate borrowing into IFAD’s financial framework and planning. This will put an end to a situation where funding gaps arise for a certain level of desired PoLG, which have to be bridged with ad hoc borrowing deals. Using borrowing to bridge the resource requirements between pledged contributions and a desired level of PoLG leads to suboptimal planning capability, since Management cannot predict whether borrowing deals will be available and viable as and when needed. This is despite IFAD having adopted a clear legal framework for borrowing with the SBF.¹³
42. An approach based on “leveraging available resources” could therefore be introduced. This would strengthen the link between contributions and other sources of funding, on the one hand, and PoLG on the other: the target PoLG level would be determined by demand for IFAD assistance and the capacity to deliver it, and there would be no uncertainty as to the resources available to fund the desired PoLG

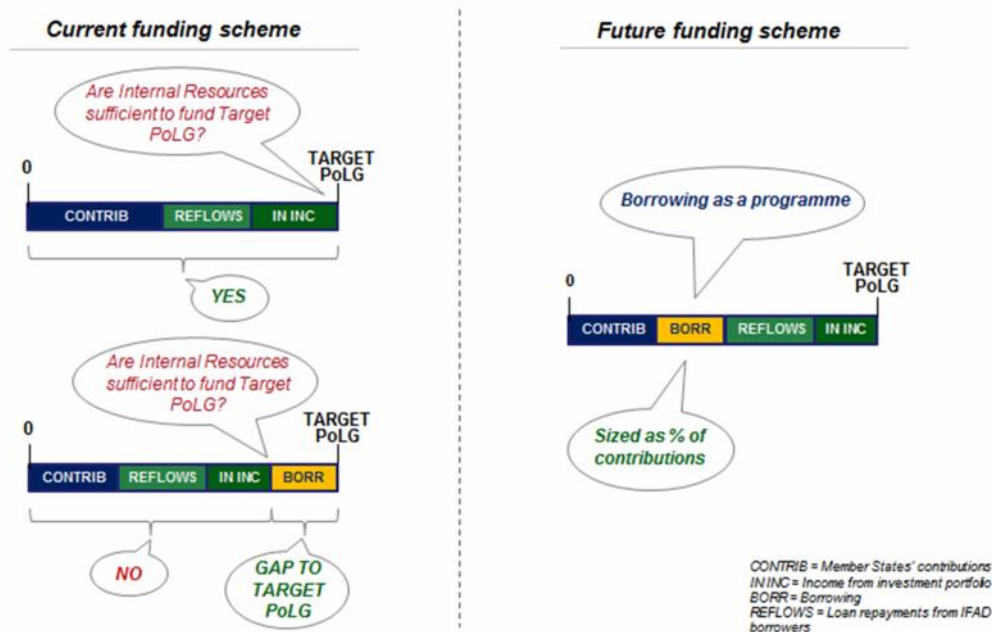
¹³ See EB 2016/118/R.30, paragraph 22.

level. These would be pursued in the context of the prudential leverage and risk parameters established for the Fund.

43. Under this approach, Member contributions will remain the bedrock of IFAD's capital and financial commitment capacity. They would then be used as a basis for maintaining and/or expanding IFAD's commitment capacity.
44. Such an approach would represent further progress from what IFAD has already achieved through the SBF, since it would provide a rule-based methodology for embedding funds that are borrowed – whether from sovereign entities or from the capital markets – in a stable manner into IFAD's capital structure.
45. Chart 2 illustrates the logical steps followed by management when addressing IFAD's financial needs. On the left is a diagram that depicts the current approach. At any given replenishment, Management would evaluate IFAD's commitment capacity to fund the PoLG by looking at available resources, given by: (i) Member contributions; (ii) loan reflows; and (iii) investment income. If this envelope is sufficient to fund a desired level of PoLG according to IFAD risk policies (mainly the MLR), then there will be no need to borrow. If, instead, a shortfall is detected on the basis of the MLR (basically, IFAD's long-term cash flow sustainability) then Management would seek Executive Board approval to borrow – in order to make up for that specific shortfall.

Chart 2

IFAD's current and future funding scheme



46. The right-hand side of chart 2 shows the new financial strategy that Management is proposing. It is based on the same concepts as before, i.e. primary reliance on Member contributions and loan reflows. In this strategy, borrowing (through one of the options described in section V below or a combination thereof), would be an integral part of IFAD's funding mechanism, in an amount defined as a specific percentage of Member contributions for every replenishment cycle.
47. There are two advantages in this approach: (i) it maintains strong Member support by keeping contributions at the heart of IFAD's financial architecture; and (ii) it makes it possible to leverage IFAD in a way that is guided by a prudential risk management framework, while at the same time controlled by the Membership through the size of their contributions.

48. Management proposes that borrowing capacity initially be established in a proportion of up to 50 per cent of Member contributions at every replenishment. This proposed ceiling is founded on a number of simulations and resulting financial scenarios which show that such a ratio is financially viable. It also gives Management the necessary flexibility in planning IFAD's future liquidity needs to fund the designed level of PoLG, while maintaining prudent risk levels. Management believes that this level is adequate to guarantee a prudent approach at the outset of IFAD's leveraging strategy. Given the Fund's strong initial equity position, such an approach could be reviewed once sufficient experience is accumulated.

B. Impact on resource allocation

Implication for resource allocation by recipient type

49. It is very important to clarify the linkage between the proposed leverage strategy and the use of IFAD's resources. As already highlighted in section IV.A., IFAD represents a blend between the soft loan window (typically the "Fund") and the commercial window (typically "ordinary capital") of other IFIs; and it is mandated to use a substantial part of its resources for concessional lending to countries classified as highly concessional borrowers. The proposed leverage strategy would not prevent this from continuing, nor would the share of the overall financing to such countries decrease proportionally.
50. The increase in leveraging to fund ordinary loans means that a larger share of IFAD's core replenishment resources, intended as Member States' contributions, is used to finance highly concessional loans. Eventually, all IFAD core resources would be channeled into highly concessional uses. Management proposes that up to 10 per cent of core resources be directed to UMICs. Over time however, this percentage will gradually decrease as the leverage strategy is implemented, until it reaches 0 per cent.
51. This would represent a financially viable and more efficient use of resources: highly concessional lending and grants would eventually be fully financed by grant contributions from Member States. The ordinary loan window would be financed increasingly by borrowed funds. This would allow the Fund to grow its overall PoLG for all type of users, making sure that all categories of beneficiaries are positively affected. The reflows from ordinary loans would be partly used to fulfil borrowing obligations. Moreover, higher lending to countries borrowing on ordinary terms would also generate an excess of reflows that could further reinforce IFAD core resources and hence be directed towards highly concessional allocation.

Implications on PBAS

52. In a context where IFAD's resources are primarily – but no longer exclusively – Member contributions in grant form, the issue of how to allocate resources in an efficient, sustainable and transparent manner comes back to the table. IFAD has recently conducted a review of the PBAS, the result of which has been shared with the Executive Board for approval.
53. In the future, as IFAD completes the transition of its financial architecture, the issue of applying the PBAS across the whole spectrum of the PoLG will have to be addressed.
54. Currently IFAD applies the PBAS irrespective of the type of financial assistance it provides: its financial resources are allocated to Members according to the same methodology, with no distinction in financing terms, recipient country category, or source of funding, as noted elsewhere in this paper. This is consistent with the fact that the size of the PoLG is established a priori and the resources are then distributed among prospective borrowers in a fair manner.
55. As mentioned above, IFAD is probably unique in applying a performance-based allocation system throughout its resource base; and this may become increasingly difficult to maintain as the Fund opens up its capital structure further. Once IFAD

starts to leverage its resource base by accessing the capital markets and the size of the PoLG (primarily for ordinary lending) is determined, other criteria and dimensions will have to be incorporated into the decision process for resource allocation to ensure that ordinary lending can be supplied by the Fund in a context of manageable risk levels. These may be: country exposure, portfolio concentration, capital adequacy and other risk management parameters. Moreover, given that resources lent on ordinary terms will primarily respond to demand and would therefore not be pre-determined, the PBAS will not necessarily apply to these. The PBAS, following the practices of other IFIs, would then be applied to concessional resource allocation only.

56. Nonetheless, this change is only a possible example of a further review to the PBAS, which may be needed in the future if and when IFAD proceeds with a borrowing strategy; it is not necessarily a change to be pursued during IFAD11.

Implications for product range

57. Following the indication of the Audit Committee, and in recognition of the Fund's evolving financial structure, in 2016 IFAD conducted an in-depth review of its lending products and lending terms, through a corporate working group with representatives from all divisions involved.
58. The working group was tasked with making a review of IFAD's financing policies and criteria, covering strategic, legal, operational and financial aspects.
59. The working group's final recommendations were presented to, and endorsed by, Management in December 2016. They included a number of action points, all aimed at better positioning IFAD to respond to the need for more flexibility in its product range; and a stronger financial link between the demand for, and supply of, funds to respond to growing financial challenges, but also in line with the increasing sophistication of IFAD's financial framework and capacity.
60. The working group will continue with its planned work and deliverables beyond the IFAD10 period and into IFAD11; and it will serve as the forum where IFAD ensures a financial linkage between its funding sources and product range. All recommendations and proposed measures will be discussed with the governing bodies. Table 4 shows IFAD's current financial product range.

Table 4
IFAD's lending terms

| <i>Loan type</i> | <i>Maturity (years)</i> | <i>Grace (years)*</i> | <i>Interest rate</i> | <i>Service charge</i> | <i>Currencies</i> |
|---------------------|-------------------------|-----------------------|----------------------|-----------------------|-------------------|
| Highly Concessional | 40 | 10 | 0% | 0.75% | SDR/EUR/US\$ |
| Blend | 25 | 5 | 1.25% | 0.75% | SDR/EUR/US\$ |
| Ordinary | 15-18 | 3 | Variable plus spread | - | SDR/EUR/US\$ |

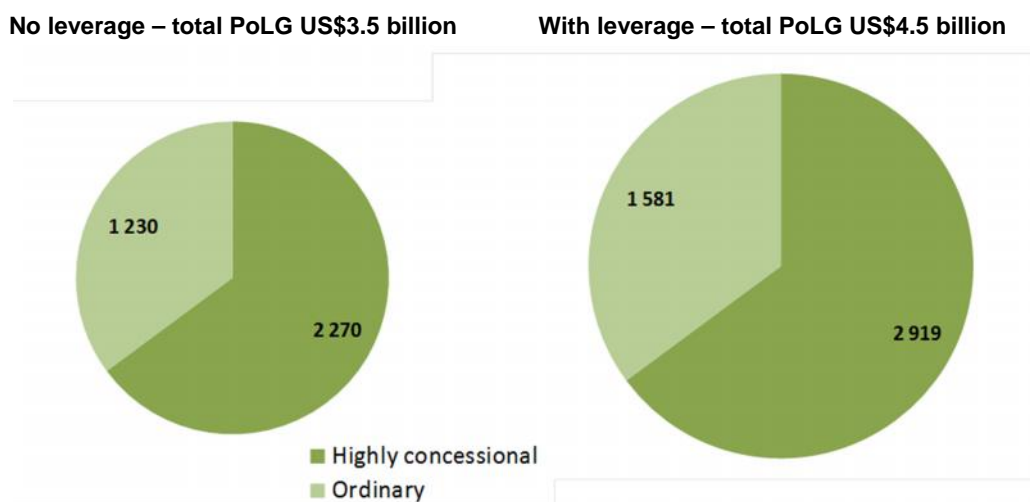
* The Executive Board may vary the grace period for the repayment of loans received on blend and ordinary terms not exceeding six years.

Benefits from leveraging

61. The leveraging strategy described here would allow IFAD to grow its operations while at the same time benefiting all recipients of its funds. Chart 3 compares the resources that IFAD would be able to provide to ordinary and concessional borrowers (including grant recipients) during the IFAD11 period, with the same amount of support from Member States as in IFAD10.
62. Without borrowing, and assuming an IFAD11 replenishment level of US\$1.6 billion, IFAD would be able to deliver a PoLG of US\$3.5 billion, with US\$2.0 billion channelled to highly concessional recipients.

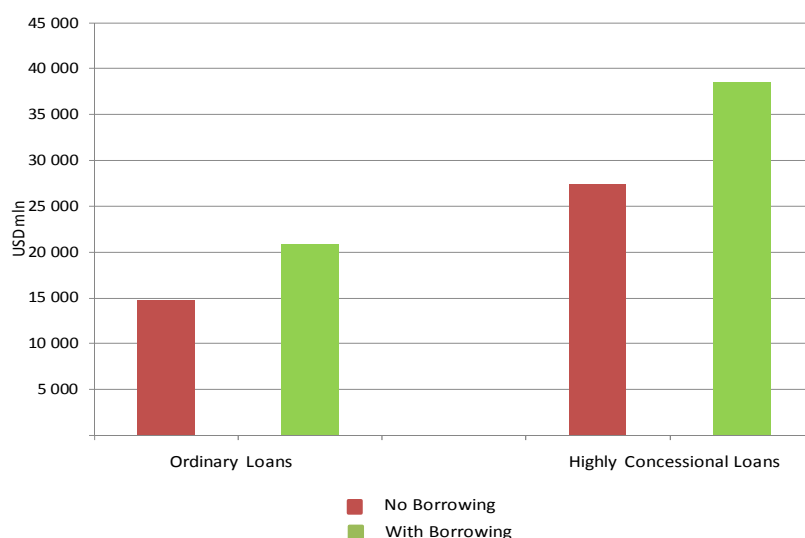
63. With the same replenishment amount, and with the implementation of a contained borrowing strategy, here assumed to be 50 per cent of Member States' contributions, IFAD would be able to fund a PoLG of US\$4.5 billion. All clients would benefit from this strategy: resources to highly concessional recipients would increase from US\$2.3 billion to US\$2.9 billion; and ordinary loans would grow from US\$1.2 billion to US\$1.6 billion.¹⁴

Chart 3
Impact of leveraging on resource allocation split in IFAD11



64. The benefit obtained in IFAD11 would be repeated in future replenishment periods: chart 4 compares cumulative resource allocation spanning IFAD11-IFAD20 to ordinary and highly concessional loans with and without borrowing; a conservative borrowing strategy (here assumed, as above, equal to a constant 50 per cent of contributions) would allow for a larger allocation to both highly concessional and ordinary borrowers, for the same level of contributions.

Chart 4
Impact of leveraging on the resource allocation split over the IFAD11-IFAD20 horizon



¹⁴ The scenario assumes borrowing fixed at 50 per cent of Member States' contributions at every replenishment. Borrowing terms are assumed in line with the SBF terms in IFAD11, and market terms thereafter.

65. The proposed strategy, in which borrowing remains confined to a certain percentage of Member contributions, leads to a very prudent financial structure, which is much more conservative than the typical IFI financial framework.
66. As detailed in this section, other IFIs usually fund the less concessional loans (similar to IFAD's ordinary loans) through the so-called "ordinary capital" window, which is financed through market borrowing. Concessional lending (comparable to IFAD's grants and highly concessional loans) is operated by the concessional arm (or fund), which is financed by periodic replenishments from their member states. IFAD represents a blend of these two windows: with a more tailored leveraging strategy it can optimize capital use, while preserving its identity as a concessional lender.
67. Simulations run by Management show that, by increasing leverage to a level closer to those maintained by peer institutions, the assets that IFAD could sustain under a prudent risk framework would increase more than twofold, from US\$8.4 billion currently to US\$21 billion in IFAD20. Table 5 below illustrates this concept. The proposed leverage strategy would result in limits for the debt/equity and equity/loan ratios, which for IFAD would imply a more conservative leveraging position than that of any other IFI at the present time.

Table 5
IFAD financial indicators, current and prospective versus current selected IFIs

| | IFAD ^a (Current) | IFAD20 (Future) | AfDB | IBRD | ADB | IDB | EBRD | IsDB | Aaa median |
|-----------------------------------|--------------------------------|--------------------|--------|--------|--------|--------|--------|--------|------------|
| Rating | n.a. | n.a. | Aaa | Aaa | Aaa | Aaa | Aaa | Aaa | - |
| Total assets | 8.4 | 20 | 48.7 | 371.3 | 117.7 | 111.1 | 59.8 | 22.7 | 73.6 |
| Equity/loans^(b) | 130% | Min. ratio 50% | 47.0% | 21.8% | 27.8% | 32.1% | 53.5% | 67.4% | 39.6% |
| Debt/equity | 3.3% | Max. ratio 100% | 253.9% | 494.9% | 378.6% | 313.5% | 252.8% | 101.8% | 253.9% |

Note: ADB – Asian Development Bank ; IDB – Inter-American Development Bank; EBRD – European Bank for Reconstruction and Development; IsDB – Islamic Development Bank.

^a Source: Consolidated Financial Statements of IFAD as at 31 December 2016; IBRD data as of end-of-year 2016; all other data as of end-of-year 2015.

^b Ratio of total shareholder equity excluding callable capital to gross loans outstanding.

C. Requirements to upgrade IFAD's internal structure for effective management of a borrowing programme

Need for an enhanced risk management framework

68. IFAD's commitment capacity is in all events constrained by its prudential liquidity buffer, in line with its Liquidity Policy. Consistent with a prudent strategy for introducing borrowing, IFAD's SBF has also introduced a series of ratios to ensure that borrowing is undertaken in a prudent way. These are the maximum debt-to-equity ratio, the MLR ratio, and the maximum debt-service-coverage ratio.
69. Should a decision be taken to pursue the leveraging strategy described above, IFAD's risk management framework would be further strengthened to ensure maximum mitigation of the leverage risks. The proposal is to complement the existing framework contained in the SBF with an additional set of policy measures and financial ratio requirements, to significantly strengthen IFAD's risk management. These will be based on:
- (i) Donors' support: as mentioned above, Member contributions are the bedrock of IFAD's financial resources and will remain so;
 - (ii) Balance sheet optimization: Management will leverage those resources gradually and progressively, to make sure there is always a strong equity position (i.e. Member contributions) to sustain IFAD's loan portfolio. The financial ratios in place (in a nutshell, how much in borrowed funds can be

- added to a given level of contributions) will prevent leverage from escalating to levels that are either excessive or unmanageable;
- (iii) Prudent liquidity management: IFAD's current very prudent policies in terms of liquidity coverage through the MLR would remain in place. However, they might need to be re-evaluated once further experience is gained, to bring IFAD practices into line with those of peer IFIs, and particularly to remove the long-term constraint from the MLR and bring it more in line with these institutions;
 - (iv) Full integration of derivative capabilities, in order to manage the interest rate and currency risk arising from borrowing;
 - (v) Pursuit of the highest possible rating and debt issuance programme in the capital markets, to keep IFAD access to capital open even in times of market distress; and
 - (vi) Integration of loan portfolio credit monitoring in IFAD's existing prudential framework: Management will continue to take steps to strengthen the monitoring and management of country exposure, by establishing regular country credit risk analyses and the assessment of concentration risk to ensure optimal diversification of country exposure.
70. These concepts are summarized in table 6.

Table 6

Enhanced risk management framework

| Risk | Mitigation |
|--|--|
| <ul style="list-style-type: none"> • Interest rate and currency risk • Credit risk • Financial market disruptions may hinder access to borrowing, roll over of old borrowings and new disbursements • IFAD's own situation may adversely affect its credit rating and hinder its access to borrowing | <ul style="list-style-type: none"> • Progressive integration of derivatives as a way to hedge these risks in line with practise of peer institutions • Strengthened country credit monitoring and concentration risk management • Prudential liquidity Also, market disruptions usually lead to "flight to quality", i.e. more beneficial than disruptive to borrowers with high credit ratings • Prudential framework <ul style="list-style-type: none"> ✓ Enterprise Risk Management Committee ✓ Risk management within Financial Operations Department |

Human resources

71. If IFAD fully incorporates borrowing into its capital structure, as proposed in this paper, the Fund will probably have to create a unit dedicated to funding, as exists in other IFIs. The size of this unit and its location in the organization chart varies from entity to entity, mainly reflecting the size and complexity of funding operations: they can be as large as to have over a dozen staff and may be elevated to department level in the case of larger IFIs.
72. For IFAD however, additional front-office staff requirements are not likely to exceed two units for the foreseeable future (one with debt issuance experience and another with derivative experience), and possibly two additional administrative staff. Management bases this assumption on the following considerations:

- (i) IFAD's borrowing programme (be it SBF, concessional partner loan [CPL] or capital markets) is going to be implemented very gradually, and issuance size will remain modest compared to other IFIs. By way of comparison, KfW Development Bank regularly issues around US\$60 billion per year, while IFAD would not be expected to exceed US\$1 billion per replenishment cycle over the next few years.
- (ii) IFAD's Financial Operations Department (FOD) already employs several staff with significant experience in debt capital markets, derivatives, risk management, ratings advisory services and management of large and complex debt issuance programmes.
- (iii) As described in paragraph 26, over the past two years, IFAD staff have been receiving specific and dedicated training on debt and derivatives.

New risk management and transaction execution systems

73. IFAD has already made substantial progress in this area, by:

- (i) Further developing the internal database and trade compliance system in the Treasury Services Division;
- (ii) Re-engineering IFAD's financial model; and
- (iii) Fully exploiting the capabilities of the market-standard Bloomberg system: IFAD is progressively migrating all transaction execution and most risk calculations for day-to-day portfolio management decisions on to the Bloomberg platform, in line with standards followed in the financial market.

74. However, as the Fund decides to move further towards leveraging, a new risk management system will likely have to be implemented, particularly to manage the derivative transactions needed to hedge currency, credit and interest-rate risks. This will require some capital expenditure which can be described in further detail in the feasibility study paper on borrowing from the capital markets, to be submitted to the Executive Board in September 2017.

Fine-tuning of internal policies

75. As briefly mentioned elsewhere in this paper, some IFAD internal policies may have to be revised for borrowing to fully fit into the Fund's business model. In particular, the following policies may have to be revisited:

- (i) The resources available for commitment (RAC) policy. Currently the RAC formula is designed to calculate the maximum PoLG level that IFAD can sustain by considering contribution resources, loan reflows and investment income. Furthermore, the policy is designed for an entity that works "like a fund" i.e. it can only use resources that are readily available. This policy will have to be re-written in order to consider that – with the capacity to borrow – IFAD may have the ability to access financial resources on an "if and when needed" basis. This obviously assumes that borrowing remains within a set of pre-agreed leverage ratios, as explained in this paper.
- (ii) The MLR policy. This policy will have to be re-written for the same reasons as above.
- (iii) The PBAS policy. In addition to the changes agreed at the April 2017 Executive Board, this policy will have to be reviewed in line with the decisions taken, as described in section IV.B above.

76. In order to implement the changes described above, Management and the Executive Board will benefit from two initiatives, which will provide a reliable third-party opinion on the initiative to leverage IFAD's capital through borrowing, particularly from the capital markets:

- (i) The ongoing corporate-level evaluation of IFAD's financial architecture. This work has been started by the Independent Office of Evaluation of IFAD; and extensive conversations have already taken place with FOD and treasury staff in particular; and
- (ii) A peer review that IFAD could potentially commission from one of the other IFIs, to assess, independently and based on its own experience, the Fund's degree of preparation for borrowing on the capital markets.

V. Ways to leverage IFAD

- 77. IFAD Management has already brought the Executive Board up to date in an informal technical seminar, held on 5 April 2017, on the possibilities presented by leveraging the Fund within a set of pre-agreed financial ratios aimed at controlling risk.
- 78. To proceed with the diversification of its resource base, IFAD could adopt different options, building on the expertise already accumulated with the SBF and in the negotiations with sovereign lenders. The following sections describe three different leverage options.

A. Continuing to expand the SBF

- 79. As highlighted in its first review,¹⁵ the SBF is proving a valuable instrument for IFAD by providing clear guidelines on the management of borrowed funds, as the Fund engages in discussions with potential sovereign lenders for additional loans.
- 80. IFAD has so far borrowed EUR 300 million to finance part of the IFAD9 PoLG, and an equal amount to approve loans under the IFAD10 PoLG. With these two borrowing arrangements, IFAD is still comfortably within the financial ratios prescribed by the SBF, and it would still have considerable leeway to borrow under that framework.
- 81. One possible risk that needs to be recognized, however, is that IFAD cannot be certain of continuous access to viable sovereign borrowing arrangements as and when needed. This is called refinancing risk. The availability of sovereign lenders and financial conditions (currency, interest rate and maturity) that suit IFAD's sustainability conditions are not under the Fund's control.

B. Concessional partner loans

- 82. The CPL is a loan offered to an IFI by a development partner (usually a Member State) under concessional terms. These include well-below market interest rates, long maturities and long grace periods. Due to their concessional terms, such loans embed a grant element and they supplement available grant resources for concessional lending.

Potential application to IFAD

- 83. Should IFAD include CPLs in the replenishment as part of its financing sources, one way to proceed would be to apply the same principles and financial conditions as implemented by IDA and the African Development Fund (AfDF). Depending on the financial terms of the CPL, IFAD could use the CPL to finance part of its PoLG on a self-contained (or self-sustainable) basis. As shown in table 3 above, IFAD lends at blend and highly concessional terms, applying a fixed interest rate/service charge.
- 84. If the terms of the CPL are similar to those on loans to IDA or AfDF, on the principle that they should be at least as concessional as the lending they finance, IFAD could channel the CPLs to finance blend and/or highly concessional loans without incurring term-structure or interest-rate risk.
- 85. In the case of IDA, the donor's indicative expression of interest for contributing to the IDA17 replenishment through the CPLs played a key role in determining the

¹⁵ See EB 2016/118/R.30.

final discount rate. Therefore, in the case of IFAD, an early indication of amounts, financial conditions and currency of a CPL would be crucial to allow for the correct calculation of the appropriate discount rate.

86. Should IFAD include CPLs as a funding option, the implications for the governance structure would need to be agreed on. All other IFIs attribute voting rights to Member States agreeing to extend concessional loans in an amount proportionate to the grant element embedded in the loans. This raises the risk of substitutions for replenishment resources, which IDA and AfDF address similarly to IFAD in the SBF.¹⁶

Cost

87. The cost of the CPL for IFAD could be estimated as similar to the CPLs granted to IDA. The latter's concessional loans have an all-in SDR equivalent coupon of up to 1 per cent. Donors have the option of providing additional grant funding to bridge the gap between the coupon rate on the CPL and their target coupon rate if higher. In IDA18, the coupon rate of the CPLs in national currency was between 0 and 0.47 per cent. For modelling purposes, IFAD will assume a spread on the relevant variable rate of 0.00 per cent.
88. It should be also noted that, like sovereign borrowing, CPLs could be subject to refinancing risks as there is no certainty that, in every future replenishment Member States would be willing to lend to IFAD in the amounts needed and under the conditions that maintain IFAD's financial sustainability. Annex II presents a review of the experience of CPLs in other IFIs.

C. Borrowing from the capital markets

89. Among United Nations specialized agencies, only the World Bank (through IBRD) currently finances itself in this way. IDA is planning to start borrowing soon, having recently obtained approval to do so and received an AAA rating from two major rating agencies. All other MDBs finance themselves by leveraging donor resources through debt issuance on the capital markets.
90. For IFAD, moving to capital market borrowing would have several advantages. Market borrowing would represent an additional funding source which would provide for diversification and complement the already existing SBF. Should IFAD obtain a high credit rating, it could count on stable access to funds with limited refinancing risk; it could also optimize its ALM through better matching of its currency of exposure, in particular.
91. A paper containing a feasibility study, with technical steps required to access the capital markets, will be submitted to the Fund's Executive Board in September 2017.

Credit rating as a pre-condition to borrowing

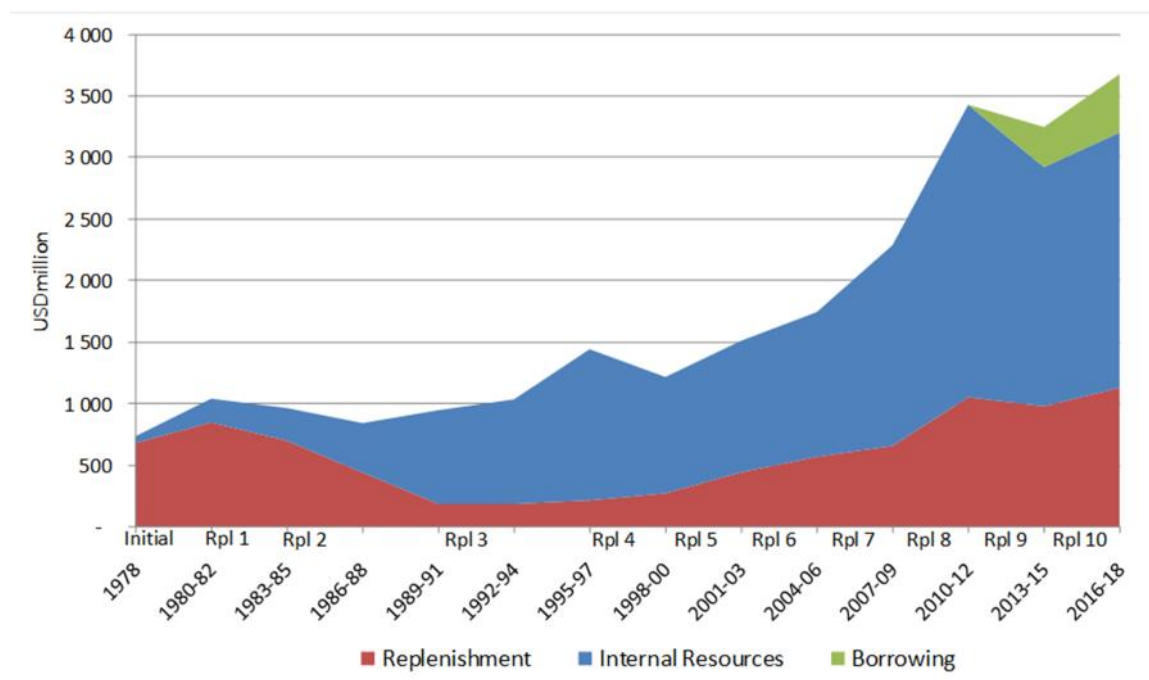
92. Obtaining a high credit rating is a pre-condition for borrowing at terms that are financially viable for IFAD. In turn, such an outcome would benefit recipient countries, as they would be able to borrow from IFAD on more favourable terms. Management understands the main criteria that drive the major rating agencies' credit assessments of IFIs and MDBs. While IFAD can count on a number of positive factors that would support a strong rating, it also has some limitations that would need to be addressed.
93. On the positive side, IFAD has a very solid capital base, primarily funded by equity and only very limited leverage. Furthermore, its liquidity position is strong and safeguarded at all times by a conservative liquidity policy. As depicted in chart 6, replenishments over time have demonstrated robust support for the institution from its Member States. Moreover, like all other MDBs, IFAD enjoys "preferred creditor"

¹⁶ See EB 2016/118/R.30 para. 22. This was also addressed in the SBF by the introduction of a specific clause: see EB 2015/114/R.17/Rev.1, para. 8.

treatment, as demonstrated by the strong track record in repayments by its borrowing countries.

Chart 5

Evolution of IFAD financial resources since the Fund's inception



94. IFAD also faces challenges in obtaining a strong rating. These are embedded in its nature as a concessional lender, and could represent a possible risk in a rating process. One of these is IFAD's current arrangement for compensating for foregone reflows under the Debt Sustainability Framework. This is discussed in more detail in the "Review of IFAD's Debt Sustainability Framework and proposal on future approach" document also being submitted to the second session of the IFAD11 Consultation (see IFAD11/2/R.6).
95. Another challenge is represented by IFAD's portfolio of outstanding loans. The weighted average rating of IFAD borrowers is BB, not including borrowers for which a rating is not available. While this can be considered a low rating by commercial standards, IFAD's loan portfolio is highly diversified in terms of products and country exposure. In addition, IFAD has almost no loans in arrears, and a history free of default, in keeping with its preferred creditor status.
96. A further challenge stems from IFAD's investment portfolio, which has an average rating of A+. Its funds are invested according to a strategy that differs slightly from other IFIs. IFAD's investment income has been a stable source of internal resources over the decades, complementing the replenishment funds and loan reflows. While financial markets pose increasing challenges, IFAD strives to achieve the highest possible return in a non-speculative manner, within its approved risk budget. For that reason, its investment portfolio has a higher credit exposure and a broader rating spectrum than other IFIs. Moreover, for reasons discussed in further detail in section III above, borrowed funds awaiting disbursement are invested with an ALM strategy aimed at matching borrowing costs.
97. The current limited use of derivatives to hedge against risks, which is standard in peer IFIs, could also pose challenges within the rating process. As noted in paragraph 67, Management is aware of this issue and is taking proactive steps to enhance IFAD's capacity in this respect.

98. To conclude, a successful rating outcome is crucial for the evolution of IFAD's leverage strategy.

D. IFAD11 scenarios

99. In line with the strategy presented in this document, the following section illustrates the possible financial scenarios for the IFAD11 period. However, as stated earlier in this paper, it is assumed that the impact on resources resulting from strategic changes to the business model will materialize beyond the IFAD11 period over the medium-to-longer term (as set out above in section IV).
100. The proposed level of PoLG for IFAD11 is US\$4.0 billion. The target for IFAD11 contributions is assumed at US\$1.4 billion versus a revised target in IFAD10 of US\$1.35 billion. This is very ambitious, but in line with IFAD's continued role in the context of the 2030 Agenda for Sustainable Development. For discussion purposes, Management also presents a low scenario and a high scenario, with associated levels of PoLG and contributions. These are shown in the tables presented in this section.
101. The required borrowing level is being computed in consonance with the leveraging strategy logic described throughout this paper. Borrowing is assumed to fund ordinary loans only; and, most importantly, the borrowing amount is driven by IFAD's ability to leverage up to a certain percentage of its Member contributions and keep this level of borrowing stable in the future.
102. The borrowing needed to fund the PoLG in IFAD11 will therefore be assumed to be repeated in all future replenishments at the same real level. This represents a major departure from the borrowing scenarios presented in IFAD10, where borrowing was assumed only in a specific replenishment cycle. This methodology is more correct, in recognition of the fact that borrowing, whether under market terms or through the SBF, is seen as a funding tool for IFAD alongside the main channel, i.e. Member contributions.
103. Therefore, it should be realistically assumed that the amount of borrowing needed to support the Fund will not decrease over the years, but instead it will be rolled over year by year as it matures. IFAD wants to maintain its prudent long-term view, to avoid jeopardizing its future financial stability; and it will only declare a borrowing level sustainable if it can safely be repeated in the future.
104. As a result, a scenario will be considered sustainable if it respects the following constraints:
- PBAS constraint: the PBAS as presented in section IV above must be maintained;
 - The MLR must be respected;
 - The borrowing must be self-sustainable; and
 - The leverage ratios will be as proposed in table 4 of this paper, which may require an adjustment to those specified in IFAD's Sovereign Borrowing Framework.

Scenario results

105. Borrowing during IFAD11 is estimated at a level of US\$700 million in the central scenario, equivalent to 50 per cent of contributions, and flat in real terms over the future replenishment periods.
106. Under this scenario, all the constraints described in this paper are respected. Table 7 below summarizes the resulting resource allocation.

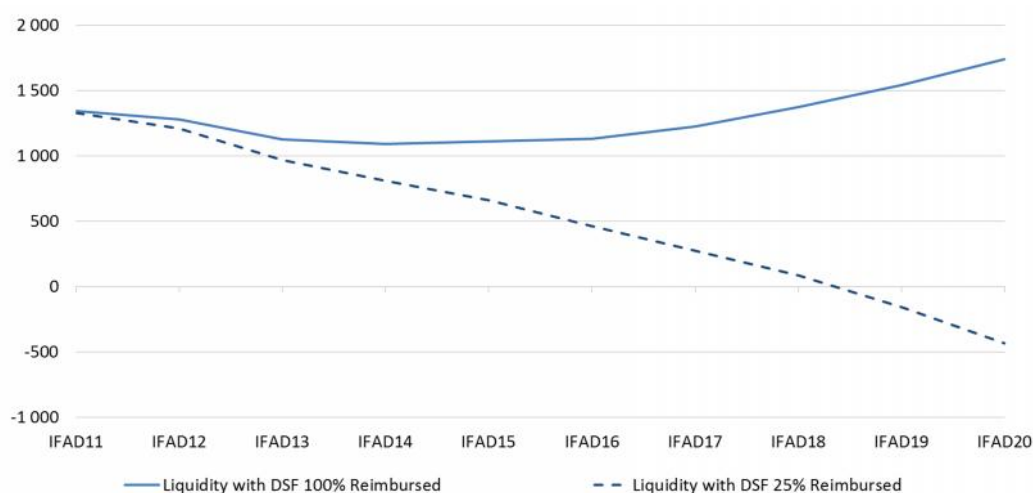
Table 7
Proposed IFAD11 scenarios
 (Millions of United States dollars)

| | <i>Low scenario</i> | <i>Central scenario</i> | <i>High scenario</i> |
|--------------------------------|---------------------|-------------------------|----------------------|
| Contributions | 1 300 | 1 390 | 1 620 |
| Borrowing | 160 | 695 | 810 |
| <i>Borrowing/contributions</i> | Up to 50% | Up to 50% | Up to 50% |
| PoLG | 3 300 | 4 000 | 4 500 |

Implication of the Debt Sustainability Framework

107. All of the scenarios for IFAD11 and the future of the Fund, particularly over the medium- to long-term horizon, will be heavily affected by the assumptions made about the reimbursement to IFAD of interest and principal repayments forgone as a result of the DSF.
108. Since its introduction in 2007, IFAD has granted DSF financing of SDR 1,086 million (as at 31 December 2016), which is scheduled for repayment between 2016 and 2056. At 31 December 2016, cumulative DSF disbursements amounted to US\$ 805.9 million.
109. Should IFAD not be fully compensated for the reflows foregone as a result of DSF approvals, its financial position would be significantly endangered and it would be forced to cut back its operations drastically.
110. Chart 6 shows the impact on IFAD's liquidity if only 25 per cent of foregone principal reflows were to be compensated.
111. As shown by chart 6, liquidity would be drastically impacted. IFAD would need to significantly scale down its operations to keep liquidity above the MLR. Over the IFAD11-IFAD20 horizon, the PoLG would need to be downsized by some US\$673 million on average in each replenishment cycle.

Chart 6
Impact of reduced DSF compensation on IFAD's liquidity



E. Impact of different types of borrowing on the PoLG

112. Table 8 shows the impact on IFAD's growth under each of the low, central and high scenarios: assuming the same level of Member contributions, the PoLG of a "base scenario" without borrowing is compared with the PoLG level that the Fund would be able to achieve in IFAD11 by introducing a prudent leveraging strategy where the borrowing terms differ according to the option.

113. In each replenishment cycle, leveraging is assumed to be up to 50 per cent of Members' replenishment contributions, which would respect the financial ratios prescribed by the SBF.

114. The strategy presented throughout this paper – and illustrated in the table below – would allow IFAD to increase the IFAD11 PoLG by between 25 and 40 per cent relative to IFAD10.

Table 8

Alternative leveraging options – impact on IFAD11

(In millions of United States dollars)

| | <i>Base scenario</i> | | <i>Option 1</i> | | <i>Option 2</i> | | <i>Option 3</i> | |
|--------------------------------|----------------------|------------|----------------------------|------------|-----------------------------------|------------|-------------------------|------------|
| | <i>No borrowing</i> | | <i>Sovereign borrowing</i> | | <i>Concessional partner loans</i> | | <i>Market borrowing</i> | |
| Low scenario | | | | | | | | |
| Contributions | 1 300 | | 1 300 | | 1 300 | | 1 300 | |
| Borrowing | - | | 160 | | 160 | | 160 | |
| Borrowing/contributions | | | Up to 50% | | Up to 50% | | Up to 50% | |
| PoLG | 2 908 | | 3 341 | | 3 344 | | 3 300 | |
| Grant | 189 | 7% | 217 | 7% | 217 | 7% | 215 | 7% |
| DSF | 509 | 18% | 585 | 18% | 585 | 18% | 578 | 18% |
| Highly concessional | 966 | 33% | 1 110 | 33% | 1 111 | 33% | 1 096 | 33% |
| <i>Total concessional</i> | <i>1 664</i> | <i>57%</i> | <i>1 912</i> | <i>57%</i> | <i>1 914</i> | <i>57%</i> | <i>1 888</i> | <i>57%</i> |
| Ordinary | 800 | 28% | 919 | 28% | 920 | 28% | 908 | 28% |
| Blend | 444 | 15% | 510 | 15% | 511 | 15% | 504 | 15% |
| Central scenario | | | | | | | | |
| Contributions | 1 390 | | 1 390 | | 1 390 | | 1 390 | |
| Borrowing | - | | 695 | | 695 | | 695 | |
| Borrowing/contributions | | | Up to 50% | | Up to 50% | | Up to 50% | |
| PoLG | 3 203 | | 4 126 | | 4 395 | | 4 000 | |
| Grant | 208 | 7% | 268 | 7% | 286 | 7% | 260 | 7% |
| DSF | 560 | 18% | 722 | 18% | 769 | 18% | 700 | 18% |
| Highly concessional | 1 064 | 33% | 1 371 | 33% | 1 460 | 33% | 1 329 | 33% |
| <i>Total concessional</i> | <i>1 833</i> | <i>57%</i> | <i>2 361</i> | <i>57%</i> | <i>2 515</i> | <i>57%</i> | <i>2 289</i> | <i>57%</i> |
| Ordinary | 881 | 28% | 1 135 | 28% | 1 209 | 28% | 1 100 | 28% |
| Blend | 489 | 15% | 630 | 15% | 671 | 15% | 611 | 15% |
| High scenario | | | | | | | | |
| Contributions | 1 620 | | 1 620 | | 1 620 | | 1 620 | |
| Borrowing | - | | 810 | | 810 | | 810 | |
| Borrowing/contributions | | | Up to 50% | | Up to 50% | | Up to 50% | |
| PoLG | 3 500 | | 4 682 | | 4 986 | | 4 500 | |
| Grant | 228 | 7% | 304 | 7% | 324 | 7% | 293 | 7% |
| DSF | 613 | 18% | 819 | 18% | 873 | 18% | 788 | 18% |
| Highly concessional | 1 163 | 33% | 1 556 | 33% | 1 657 | 33% | 1 495 | 33% |
| <i>Total concessional</i> | <i>2 003</i> | <i>57%</i> | <i>2 679</i> | <i>57%</i> | <i>2 853</i> | <i>57%</i> | <i>2 575</i> | <i>57%</i> |
| Ordinary | 963 | 28% | 1 288 | 28% | 1 371 | 28% | 1 238 | 28% |
| Blend | 534 | 15% | 715 | 15% | 761 | 15% | 687 | 15% |

115. As shown in table 8, for the central scenario, the IFAD11 PoLG that is achievable without borrowing is US\$3.2 billion. Should IFAD enter into sovereign borrowing arrangements in the amount of US\$695 million in IFAD11, as shown in option 1, the achievable IFAD11 PoLG would be US\$4.1 billion.
116. If the same amount were borrowed through concessional partner loans at terms similar to those obtained by IDA and described in paragraph 87, the achievable PoLG would be higher and close to US\$4.4 billion (option 2 of the central scenario in the table), assuming the same level of replenishment contributions. This stems from the fact that borrowing under the CPL is less onerous for IFAD and thus allows for a larger commitment capacity.
117. Should IFAD gain access to capital markets and fund itself through bond issuance, the possible PoLG would be the one presented in the central scenario's option 3, i.e. US\$4.0 billion. The fact that the resulting PoLG is slightly lower than the other borrowing options mainly reflects the way the current MLR policy works, which is tailored to an institution that does not include borrowing in its capital structure. As explained earlier in this paper (paragraph 75 on fine-tuning internal policies), this policy will need to be altered as IFAD implements its borrowing strategy.
118. It is important to note that the foregoing results are heavily influenced by IFAD's current approach to calculating the sustainable PoLG under the SCF approach. As described in section I.B., under the SCF approach the achievable PoLG in any given replenishment period is constrained by the MLR which is "checked" for a 50-year time horizon. This approach is in line with the "fund" arm of the other IFIs, rather than with their less concessional window, which typically applies the MLR only for the following 1-2 years and relies instead on the risk management ratios for financial sustainability. As noted in paragraph 68, this would need to be addressed as part of a review of IFAD's Liquidity Policy.

VI. Conclusions

119. From IFAD9 onwards, the Fund has been taking major steps to enhance the sophistication of its financial framework to respond to a challenging and evolving environment, on both the funding and the resource-usage fronts. Diversification of funding sources with the introduction of borrowing was done gradually and went hand-in-hand with innovative policies like the Sovereign Borrowing Framework. The organization experienced a quantum leap in financial knowledge and capacity, as well as awareness of the need for a closer link between finance and operations.
120. Systems and indicators were enhanced to refine financial projections and broaden the risk monitoring spectrum. The review of IFAD's lending terms and of the PBAS allocation mechanism respond to the need for flexibility and innovation in IFAD's operations, with the aim of aligning to IFI best practices.
121. Member States' support through replenishment contributions has proven strong and stable over past cycles. IFAD is now at a crossroads: to continue growing the size of its operations it needs to fully exploit the financial potential of its equity. Mainstreaming leveraging, in line with all the other IFIs, is only the last natural step in recognizing that IFAD should now operate fully like an IFI.
122. As shown in section IV, a rolling leveraging strategy would represent a win-win situation for all clients: the funds channeled to IFAD's projects would increase, and so would lending to more concessional borrowers, in keeping with IFAD's mission.
123. Management is well aware of the path to follow for a coherent and structured implementation of this change: a number of operational changes will be needed to ensure the required level of financial tools and competencies. For the reasons mentioned above, derivative transactions would need to be mainstreamed; additional staff capacity would be required; and a partial restructuring within FOD might be needed to create a sound structure for market-based operations. A new IT

platform might be necessary to further enhance financial risk monitoring and mitigation.

124. Management is confident that IFAD's proven innovative capacity and support from its Member States, will enable it to successfully position itself among IFIs, thereby increasing its programme and ultimately enhancing its impact on rural poverty.

IFAD's financial model assumptions – 2016

1. IFAD's financial model is updated on a yearly basis immediately after the closure of IFAD's financial statements.
2. Assumptions are re-analysed by relevant departments, which are asked to confirm their validity or provide updates on the trends and forecasts.
3. The departments involved in this exercise are the Programme Management Department (PMD), the Accounting and Controller's Division, the Treasury Services Division (TRE) and the Office of Budget and Organizational Development.

| Loan assumptions | |
|--|---|
| Length of loan disbursement profile (from approval year) | Derived from public procurement law (PPL) analysis: Loan type dependent Maximum length: 15 years |
| Composition of loan portfolio by window (percent over loan portfolio) | In line with latest PMD data: Highly concessional: 54 per cent Ordinary: 30 per cent Blend: 16 per cent |
| Loan cancellation/reduction levels (percent of approved amount): | Derived from PPL analysis: Highly concessional: 9.9 per cent Ordinary: 9.6 per cent Blend: 22.7 per cent |
| Interest rate on ordinary loans | In line with IFAD lending terms: Variable interest rate as per IFAD's lending terms (six months SDR LIBOR forward curves from Bloomberg floored to zero) + five-year average of IBRD variable spread |
| Lending terms – grace period | IFAD lending terms: Highly concessional: 10 years Intermediate: 5 years Ordinary: 3 years Blend: 5 years |
| Lending terms – repayment period (inclusive of grace period) | IFAD lending terms: Highly concessional: 40 Years Intermediate: 20 years Ordinary: 18 years Blend: 25 years |
| Lending terms – repayment profile | IFAD lending terms: Equal instalments; starting after grace period |
| Arrears percentage | 0.2 per cent per annum on loan reflows assumed to be recuperated |
| Composition of grant portfolio by window (per cent) | In line with latest PMD data: Global/regional grants: 5.1 per cent of PoLG Country-specific grants: 1.5 per cent of PoLG DSF grants: 12.8 per cent of PoLG |
| Grant disbursement profile by window | Derived from PPL analysis Regular grants: 15 years for both windows DSF grants: 10 years |
| Grant cancellations | Derived from PPL analysis: Zero |

| Financial assumptions | |
|------------------------------|--|
| Investment return | TRE assumption: 2017: 0.25 per cent 2018: 0.25 per cent 2019: 0.50 per cent 2020: 0.50 per cent 2021 onwards: 0.75 per cent |
| Inflation | G7 average over the next five years from the International Monetary Fund 1.96 per cent per annum |

| | |
|---|---|
| Foreign exchange rates against SDR | Level at 31 December 2016 and constant in the future |
| Administrative budget and other expenses | |
| Administrative budget growth | Growing at inflation from 2016 actual amount |
| Borrowing assumptions | |
| Sovereign borrowing | Maturity: 20 years including a grace period of 5 years Amortization type: linear Interest rate: variable, specific currency forward interest rate + 0.35 per cent spread Allocation: 100 per cent to ordinary loans |
| Market borrowing | Maturity: 10 years Amortization type: bullet Interest rate: variable, specific currency forward interest rate + 0.20 per cent spread Allocation: 100 per cent to ordinary loans |
| Concessional partner loans | Maturity: 40 years including a grace period of 10 years Amortization type: linear Interest rate: variable, specific currency forward interest rate + 0 per cent spread Grant element: assumed embedded in the initial borrowed amount Allocation: 100 per cent to highly concessional loans |

Review of experience of concessional partner loans in other IFIs

1. Concessional partner loans (CPLs) were introduced for the first time as an innovative financing mechanism in IDA17 replenishment. CPLs were granted to IDA from five member countries for a total of SDR 2.3 billion (US\$3.4 billion), representing 6 per cent of the total IDA17 financing framework. The CPLs were repeated in IDA18, when five countries committed to lend a total of SDR 3.7 billion (US\$5.2 billion), representing 5 per cent of the total IDA18 financing framework.
2. The main principles underlying CPLs are:
 - (a) **Additionality:** CPLs are in addition to – and not a substitution for – core contributions. A mechanism to avoid substitution risk is embedded in the framework;
 - (b) **Self-sustainability:** CPLs must be at least as concessional as IDA credits. This means that they are self-contained and are serviced via reflows from IDA blend and transitional support credits approved during the replenishment;
 - (c) **No earmarking:** CPLs are used as part of IDA's overall pool of funding; and
 - (d) **Equal treatment and transparency:** To ensure this, IDA offered a limited number of loan options (in terms of financial characteristics).
3. In IDA, members receive voting rights proportional to the grant element of their CPL. IDA hosted several discussions to establish an equitable discount rate in order to calculate the loans' grant element since this has implications for members' incentive to provide CPLs. The discount rate should be high enough to provide an incentive to donors willing to provide concessional loans, but low enough to generate a grant element that is considered equitable by donors making all their contributions in the form of grants.
4. After several consultations, the approach used to set the discount rate was the "net income earned approach", based on actual financial benefits accruing to IDA from the use of CPLs. It was therefore calculated as the weighted average of the interest rate plus the service charge for blend countries. The weight would reflect the expected amount of lending to these two windows in IDA17.
5. The discount rate was set at 2.65 per cent during IDA17. For IDA18, two different discount rates, depending on the loan term, were agreed: 2.35 per cent for loans maturing in 25 years and 2.70 per cent for loans with 40-year maturity.
6. A prudential debt limit was introduced in IDA17. This was based on: (i) the overall concessionality of IDA lending; and (ii) the terms on which IDA would borrow.
7. When they were introduced in IDA17, IDA's management was asked to confirm that the existing framework IDA used to hedge currency risk of contributions and single currency credits could also be used to manage the currency risk of the CPLs.
8. Concessional donor loans (CDLs) were introduced by the African Development Fund (AfDF) in its Fourteenth Replenishment following the same strategy, principles and financial computation described for IDA. CDLs were used to fund AfDF loans to gap, blend and graduating countries within the PBAS. The discount rate to calculate the grant element, burden share and voting rights was computed based on the same "net income earned approach" used in IDA, and set at 1.75 per cent, which represents the interest rate and service charge of the AfDF blend terms.

Upon the introduction of CDLs, the AfDF reviewed its asset liability management guidelines to accommodate the use of the CDLs in its financial framework. The review addressed: (i) the need to increase the debt limit to accommodate CDLs; and (ii) the need to increase the prudential minimum level of liquidity to take into account CDLs' debt service requirements.

Questions and answers on IFAD borrowing from the capital markets

A. Preconditions for market access

What is the anticipated timeline for IFAD's access to the capital markets?

Depending on governing bodies' approval, IFAD may access the capital markets during IFAD11 or IFAD12. If internal preparations proceed at a satisfactory pace, borrowing operations may commence as early as IFAD11.

Which issues will rating agencies focus on when assessing IFAD's creditworthiness and what would be needed to fulfil these conditions?

As described during the presentation on market borrowing to the Executive Board in December 2016, some of the most important factors are:

- Evidence of strong support from Members States' through successful replenishments – IFAD has enjoyed continuous Member State support since inception;
- A clear legal framework for DSF compensation – a proposal on DSF will be presented at the second session of the IFAD11 Consultation; and
- A strong equity position and ample available liquidity – IFAD fulfils this condition.

IDA recently obtained a credit rating: what indications can be derived for IFAD?

There are many similarities in the way IDA and IFAD have been financed until recently. The main differences between the two institutions are:

- IDA's access to long-term concessional borrowing (through the partner loans introduced in IDA17), which IFAD is currently exploring for IFAD11;
- The supporting Member State rating – IFAD's is financed by a higher number of members but with lower average rating;
- Member State concentration – IFAD has a more diversified Membership; and
- The fact that IDA can reasonably assume and rely on transfers from IBRD income generation.

A snapshot of differences and similarities relevant to the rating process is presented in the table below, building on the December 2016 presentation to the Executive Board.

Table 1

| Factors' (+) Strength and (-) Weakness | IDA | IFAD |
|--|-----|------|
| + Equity Capital Base | ✓ | ✓ |
| + Leverage | ✓ | ✓ |
| + Liquidity | ✓ | ✓ |
| + Member support | ✓ | ✓ |
| + Preferred creditor status | ✓ | ✓ |
| - Weighted average borrower rating | ✗ | ✗ |
| - Accounting losses / asymmetry of treatment of grants and DSF | ✗ | ✗ |
| - Access to long-term concessional borrowing | ✓ | ✗ |
| Callable capital | ✗ | ✗ |
| - Member rating | ✓ | ✗ |
| - Member concentration | ✗ | ✓ |

Will market access be guaranteed to IFAD so it can borrow as planned? IFAD will have to build a reputation in the markets, alongside more established comparable borrowers, before it can gain stable and reliable access to the capital markets.

The Fund's credit rating will play a major role in this regard: obtaining the highly coveted AAA rating will ensure that IFAD joins the ranks of borrowers that can supply the safest bonds available to investors and offer reasonable comfort that capital will be available, even in times of market distress. This has been demonstrated by the experience of AAA-rated MDBs during the financial crises of recent years.

IFAD's relatively limited size is also an advantage. Borrowing needs for IFAD are anticipated to be contained in the foreseeable future (approximately US\$1 billion per replenishment cycle), which should not pose insurmountable difficulties. A well structured marketing effort, with investor roadshows and cooperation with the dealer community, should also assist IFAD in reaching international institutional investors.

B. Potential risks for IFAD and its Member States

Will borrowed funds require subsidies by general resources from donors? No. Resources provided by the donors are – and will continue to be – the basis (or the equity) on which IFAD leverages its available resources. In order to be successful, borrowing must not require continuous support from external financial resources. The principle that borrowing must be self-sustainable is established in the Sovereign Borrowing Framework.

Will IFAD risk accepting money from illicit sources when accessing funding on the capital markets?

This is highly unlikely. IFAD will not accept any payments directly: bond sales are managed through financial intermediaries, which are bound to comply with international anti money-laundering regulations and mandatory regulations for customer screening (known as “know your client”). This will reduce the risk that funds from illicit or questionable sources reach IFAD through bond issuance.

The Enterprise Risk Management Committee will assess all possible sources of risks, set appropriate risk guidelines and monitor them.

What would the implications be if market activities are not successful?

If borrowing from the capital markets is not successful, IFAD will continue pursuing other means to diversify its funding, considering the global financial challenges for official development assistance. In any case, IFAD will ensure that all preparatory steps are taken and preconditions are in place to avoid negative repercussions.

IFAD will need to build credibility and achieve penetration gradually, and may need to continue relying on sovereign borrowing during the transition period of approximately three years from the initial market borrowing.

C. Implications regarding IFAD's mandate, portfolio and allocation mode

What are the implications for the PBAS model?

IFAD currently applies the PBAS to the entire spectrum of resources allocated under the PoLG. Borrowed funds (both sovereign and market) cannot be assigned according to a pre-determined split that does not consider the recipient country's ability to repay them at IFAD ordinary terms (unless a specific subsidy is allowed from other sources). This issue will need to be considered in the application of the PBAS.

What implications are to be expected regarding the share of IFAD's financing for lower-income countries and lower-middle-income countries? The primary effect of adding borrowing (both sovereign and market) to IFAD's available resources is that core resources donated by Member States will be increasingly directed towards highly concessional use. Over time, all of IFAD's core resources will be directed towards highly concessional use. This will lead to growth in IFAD's operations, increasing the amount of resources for both lower- and middle-income countries.

What implications might IFAD's investments have in the poorest regions and in fragile situations?

Market borrowing would have no implication or impact on the size and scale of IFAD's investment in the poorest regions or in fragile situations.

Fragile states in particular are found across all categories of IFAD's operations, including lower-, lower-middle- and upper-middle-income countries.

Neither the size of allocations to these countries nor their lending terms would be affected by the funding source. On the contrary, if a leveraging strategy is pursued, all categories of IFAD beneficiary countries will receive increased funding.

D. Implications regarding IFAD's governance and internal structures

What needs to be considered in view of IFAD's governance structure, particularly with regards to amending the Agreement Establishing IFAD?

The Agreement Establishing IFAD does not address the Fund's borrowing power; it neither states that IFAD has the power nor that it is prohibited from borrowing. However article 7, section 3 provides that: "In addition to the operations specified elsewhere in this Agreement, the Fund may undertake such ancillary activities and exercise such powers incidental to its operations as shall be necessary in the furtherance of its objective". Article 2 provides that the "objective of the Fund shall be to mobilize additional resources to be made available on concessional terms for agricultural development in developing Member States". In addition, the borrowing power of the Fund has been recognized by IFAD's governing bodies when they have authorized IFAD to borrow from its Member States.

For the comfort of lenders and bondholders, borrowing from the markets may require that such power be explicitly expressed through an amendment to the Agreement Establishing IFAD. Article 4, section 1 of the Agreement could be amended to clarify this point. Such an amendment would need to be approved by a four-fifths majority of the total Governing Council votes and, unless otherwise specified by the Governing Council, would enter into force three months after its adoption.

IFAD's governance is based on contribution-based voting shares, which will not be affected by a new fundraising activity in the capital markets.