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Investing in rural people

Review of IFAD's Debt Sustainability Framework (DSF) and proposal on future approach

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Consultation on the Eleventh Replenishment of IFAD's Resources — Second Session
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For: Review

Contents

Abbreviations and acronyms

ADB	Asian Development Bank
ADF	Asian Development Fund
AfDF	African Development Fund
DSF	Debt Sustainability Framework
HIPC	Heavily Indebted Poor Countries
IDA	International Development Association
IFI	international financial institution
IMF	International Monetary Fund
MDRI	Multilateral Debt Relief Initiative
MVA	modified volume approach
PBAS	performance-based allocation system
PoLG	programme of loans and grants
SDR	special drawing right

Executive summary

1. The Debt Sustainability Framework (DSF) was adopted by IFAD in 2007 to support debt relief and management in poor countries is in order to assist them in achieving their development goals. The DSF is a hybrid product: countries eligible for highly concessional lending receive financial assistance on a grant basis rather than a loan basis (for further details, see paragraph 5 of the main report). However, IFAD is expected to be compensated for the reflows that would have occurred if the financial resources provided to these countries had been on highly concessional loan terms.

2. In the context of the Consultation on the Eleventh Replenishment of IFAD's Resources (IFAD11), delegates have requested that IFAD present a paper on its experience with the DSF – and the experiences of other multilateral institutions – regarding actual and estimated net losses for interest[1] and principal repayments. IFAD was also asked to present proposals on future approaches to compensation as per EB 2007/90/R.2, "Proposed Arrangements for Implementation of a Debt Sustainability Framework at IFAD".[2]

3. There is a risk that the current DSF compensation policy does not adequately compensate the Fund for the costs incurred to service the loans (including interest and principal repayments). This could negatively impact IFAD's resources and limit the Fund's capacity to carry out its mandate. There may also be negative repercussions when IFAD undertakes a credit rating exercise.

4. All other international financial institutions (IFIs) have adopted measures to mitigate the impact of the DSF on their commitment authorities. In general, the other IFIs ensure compensation of the following components:

   - Principal component compensation is mandatory from stakeholders and additional to standard replenishment contributions.
   - Interest component compensation takes place through a modified volume approach (MVA) under which performance-based allocation system (PBAS) allocations provided in the form of grants, according to DSF rules, are nominally discounted in order to ensure a higher allocation to countries with loans on ordinary and blended terms, generating higher loan reflows.

5. IFAD differs from other IFIs in the DSF compensation mechanisms for both the principal and interest components. At IFAD, interest flows are forgone (and not included in any compensation discussions with Member States). For principal flows however, Member States have expressed their commitment (and thus their agreement in principle) to compensate IFAD, but not necessarily additional to IFAD replenishments.

6. DSF modalities generate an immediate negative impact on IFAD's financial sustainability as a result of asymmetries and timing differences in cash flows and accounting treatment.[3]

7. Since the introduction of DSF financing in 2007, IFAD had committed DSF financing totalling US$1.5 billion[4] as of 31 December 2016 (of which, disbursements amounted to US$805.9 million).[5] This financing is expected to be repaid between

[1] While loans on highly concessional terms are free of interest but bear a service charge of 0.75 per cent per annum, the term "interest" will be used throughout the paper.
[2] It is understood that this paper should also consider principal payments.
[3] Provided that the DSF is continued as a financing instrument, as per International Financial Reporting Standards, the impact of DSF financing is immediately reflected in the retained earnings as a negative component, while the compensation is recognized only afterwards based on the receipt of the instrument of contribution.
[4] SDR-US$ exchange rate as of 31 December 2016.
[5] SDR-US$ historical spot exchange rates when disbursed.

2017 and 2056. At the end of 2016, the forgone interest amounted to US$19.1 million (the total forgone interest for 2007-2056 would be US$234.9 million).[6]

8. As of 31 December 2016, US$2.9 million was received for DSF pledges through IFAD10. Compared with the DSF compensation target of US$3.4 million, this was a US$500,000 shortfall in pledges, or 14 per cent of the total DSF compensation.

9. The current DSF compensation mechanism will have a greater financial impact in future replenishment periods when the volume of expected compensation will be significantly higher (i.e. IFAD11: US$37 million and IFAD12: US$89.5 million; for further details, see table 3 and annex I). It would not be possible to close this financing gap through borrowing activities since DSF terms are concessional and are therefore not sustainable under borrowing scenarios.

Conclusions

10. Under the DSF, IFAD agreed to give selected countries grants rather than concessional loans, which reduces the reflows due to IFAD. However, Member States have agreed to offset this loss of reflows through additional compensatory contributions above regular replenishment contributions (which are assumed to be constant over time in IFAD's financial projections at the level of the current replenishment). Until now IFAD's financial planning assumptions have counted on full compensation. If this assumption were to change (i.e. assuming partial or no compensation), IFAD would immediately have to lower the programme of loans and grants (PoLG) that is judged to be feasible (otherwise, future liquidity would fall below the allowable threshold). Under IFAD10 – the first replenishment in which DSF compensation was due – only partial compensation has been received. Management has therefore concluded that it is necessary to review and amend the DSF policy.

11. Management presents two alternative options, both of which assume that Member States uphold their commitments. Option 1 continues the DSF, but aims to assure full compensation, as in other IFIs. Option 2 terminates the DSF, lowering the expected future burden of DFS compensation on Member States, but still requiring that Member States fully compensate IFAD for DSF grants already made. Management recommends that Option 1 be adopted, noting that an assumption of partial compensation should not be considered a viable alternative under either of these two options.

12. Option 1: Continue offering DSF financing but harmonize the compensation model with that of other IFIs. This entails:

- Compensation of the interest component ensured through revision of a value in the PBAS formula incorporating a 20 per cent MVA mechanism;
- Members reaffirming, enhancing and fully honouring their commitments to compensate the Fund for the principal component in the form of DSF compensation contributions in an amount additional to replenishment targets;
- Timely payment of DSF compensation contributions; and
- Continuation of a valuable financial instrument currently available to qualifying countries.

[6] See footnote 4.

13. Option 2: Discontinue the DSF as a debt relief and debt management mechanism from IFAD11 onwards, while ensuring compensation for DSF amounts already approved. This entails:

- Higher liquidity from IFAD11 onwards since loan reflows will be assured for loans issued;
- Avoidance of a reduction in the PoLG as a result of the additional assurance of future cash flows; and
- Loss of a valuable financial instrument currently available to qualifying countries.

14. Any change to the current DSF procedures will require replenishment consultation endorsement as well as approval of the Executive Board and Governing Council. An amendment to the Agreement Establishing IFAD may also be required as explained below in section IV and annex III.

Review of IFAD's Debt Sustainability Framework (DSF) and proposal on future approach

I. Background

1. In the 1990s, public concern over the debt burdens of low-income countries together with declining aid resources and poor performance in poverty reduction provided the impetus for debt relief. A buildup of foreign debt owed by many low-income countries throughout the 1970s and 1980s left many poor developing nations with unsustainable debt burdens. With the vocal support of non-governmental organizations and other advocates, these concerns were shared by pragmatic policymakers in donor governments and international financial institutions (IFIs).

2. As a result, the overarching poverty reduction mission of the development community became a core part of multilateral institutions' agendas. Since then several initiatives have been launched:

   - The Heavily Indebted Poor Countries (HIPC) Debt Initiative was launched in 1996 by the International Development Association (IDA) and the International Monetary Fund (IMF) to reduce the excessive debt burdens faced by the world's poorest nations by forgiving a percentage of their debt (an ex post debt relief measure). In 1998, IFAD established its own HIPC trust fund. Debt relief is provided to 35 countries based on conditions determined by the World Bank and IMF.

   - The Multilateral Debt Relief Initiative (MDRI) was created in 2005 to enhance the HIPC Debt Initiative and ensure that multilateral development banks are fully compensated for the debt relief they provide. IFAD is not part of this initiative.

   - The Debt Sustainability Framework (DSF) was launched by multilateral development banks in 2005 and adopted by IFAD in 2006.[7] Its aim is to assist countries in avoiding the creation of debt (an ex ante measure). The DSF has been made available to all countries identified as having either low or medium levels of debt sustainability, as determined by a joint World Bank-IMF debt sustainability analysis.

Debt Sustainability Framework

3. The DSF is a hybrid product where eligible beneficiary countries receive financial assistance through grants. While grants do not qualify as debt for the recipients, multilateral development banks should be compensated on a dollar-for-dollar basis to preserve their commitment capacity during replenishments.

4. In all IFIs, the DSF translates the debt distress risk ratings for each eligible country into "traffic lights", which determine the share of grants and highly concessional loans made available to them. This affects the terms of financial support to projects and programmes as provided for by the PBAS. For countries eligible for highly concessional loans, it introduces a third form of financing dependant on a country's debt sustainability, as determined by the World Bank-International Monetary Fund (IMF) traffic lights:

   - Red light = Low debt sustainability; 100 per cent grant;
   - Yellow light = Medium debt sustainability; 50 per cent grant, 50 per cent loan; and

[7] Resolution 141/XXIX on the Seventh Replenishment of IFAD's Resources.

- Green light = High debt sustainability; 100 per cent loan.

5. One mechanism for compensating for the forgone interest is the MVA. With the MVA, a portion of proposed DSF financing is held back and redistributed as loans through the PBAS. Part of the portion held back could also be added to the Fund's liquidity to compensate for forgone interest. This approach is applied by several IFIs, as described in table 1 and annex II. IFAD's current MVA rate is 5 per cent, the entirety of which is reallocated to all recipient countries benefitting from the PBAS.

6. Since the introduction of DSF financing in 2007,[8] IFAD had granted US$1.5 billion[9] (1.1 billion special drawing rights [SDR]) as of 31 December 2016 (on this date cumulative DSF disbursements amounted to US$805.9 million),[10] which is expected to be repaid between 2017 and 2056.

7. The full interest component estimated on the current level of IFAD's approved DSF grants is US$19.1 million[11] (SDR 14.2 million), as reported in table 3. The overall forgone interest for 2007-2056 would be US$234.9 million[12] (SDR 174.8 million).

8. IFAD Members States need to honour their commitments in principle in order to compensate principal repayments that would have occurred if the financial resources provided to these countries had been on highly concessional terms (40 years maturity period including a ten-year grace period).[13]

9. The DSF compensation policy was approved with the adoption of the Governing Council resolution 186/XXXVIII on the Tenth Replenishment of IFAD's Resources. It should be noted that:

- IFAD adopted a compensation methodology used by the African Development Fund (AfDF) to calculate the share of each Member State's compensation to IFAD for DSF implementation. This approach to calculating compensation shares uses total pledges for the replenishment period in which grants were committed.
- For efficiency, a threshold of US$10,000 was established, below which compensation shares are not required if the amounts payable are deemed too low. All contribution amounts below this threshold have been aggregated and distributed among countries with higher compensation shares on a proportional basis to ensure 100 per cent coverage of forgone principal.
- In compensating the Fund, Member States may opt to make a single pledge of a fixed amount, from which their assessed DSF compensation contributions will be taken. Alternatively, they may pledge two separate amounts (comprising DSF and regular contributions). In the case of a single contribution, Member States' obligations towards the DSF take precedence over the regular contributions.
- New Member States that did not make pledges in IFAD7 were encouraged to make voluntary contributions. In such cases, these contributions are not taken into account in determining compensation shares.

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[8] EB/2007/90/R.2: Proposed Arrangements for Implementation of a Debt Sustainability Framework at IFAD.
[9] See footnote 4.
[10] See footnote 5.
[11] See footnote 4.
[12] See footnote 4.
[13] IFAD's Contribution to Reaching the Millennium Development Goals: Report of the Consultation of the Seventh Replenishment of IFAD's Resources (2007-2009), para. 43(d): "IFAD Member States, and particularly those who are major contributors of official development assistance, agree to compensate IFAD fully for principal repayments forgone as a result of application of the debt sustainability framework within a pay-as-you-go mechanism as adopted in IDA 14".

- Member States receive contribution votes commensurate to DSF compensation.

10. DSF compensation contributions were considered as additional contributions in the IFAD10 resolution in line with article 4, section 3 of the Agreement Establishing IFAD (i.e. voluntary contributions made in the context of any given replenishment).

11. Table 1 below compares DSF mechanisms across IFIs, with additional details in annex II.

Table 1
Comparison of DSF mechanisms across IFIs

IFI	*First DSF approved*	*First principal repayment due*	*Basis for contribution shares for DSF compensation*	*Mechanism for contributing to DSF compensation*	*Modified volume discount, percentage and methodology*
IFAD	2007	IFAD10 2016-2018	DSF compensation shares based on proportions determined from pledged contributions in year grants were approved/committed	In addition to regular contributions, either separate or as part of regular contributions agreed in principle	Grant allocations subject to 2.5 per cent (yellow light) and 5 per cent (red light) up-front volume reduction (incentive-related discount).
International Development Association (World Bank)	2005	Sixteenth replenishment (IDA16) 2012	Predetermined and pre-assigned burden shares assigned to donors at time of replenishment	Additional replenishment contributions, separate from regular contributions. Member States are expected to provide unqualified commitments over a rolling decade corresponding with the disbursement period of the current replenishment. The expected firm donor commitments provide for forgone reflows for the three years added during each replenishment.	Grant allocations subject to 20 per cent up-front volume reduction.
African Development Bank (AfDB)	2004	Twelfth replenishment (AfDF-12) 2011	DSF compensation shares based on proportions determined from pledged contributions in year grants were approved/committed	Additional replenishment contributions: Since AfDF is using the IMF/World Bank debt stress under the DSF as a methodology to determine loan and grant financing terms, the AfDF is also part of the MDRI and the methodology is as above for the World Bank.	Grant allocations subject to a 20 per cent up-front volume reduction, of which 13.3 per cent is an up-front grant charge that is added to AfDF's liquidity. The final DSF allocation of 6.67 per cent is a charges-related discount reallocated to the PBAS.
Asian Development Bank (ADB)	2005	Asian Development Fund eleventh replenishment (ADF XI) 2013	Predetermined and pre-assigned burden shares assigned to donors at time of replenishment	Additional replenishment contributions, separate from regular contributions	Grant allocations subject to 20 per cent discount, of which 15 per cent is a charges-related portion to cover forgone income and administrative charges, and 5 per cent is incentives related, which is only reallocated to ADF and gap countries using performance-based allocation shares. For fragile states, only the charges-related discount is applied; they are not eligible for a reallocation of the incentive-related portion.

II. Financial considerations

12. In addressing the impact of the DSF, both the interest and the principal compensation must be considered. In doing so, it is important to correlate these elements with the modalities adopted by other IFIs as per the underlying principle agreed upon by the Executive Board in 2007 for adopting the DSF. Learning from the recent experience of the IDA, rating agencies have noted on the IDA balance sheet that the negative retained earnings generated by debt forgiveness did not in themselves have negative impacts on the final IDA rating. This is because of the

certainty of commitments from member states replenishing IDA[14] to compensate for financial losses incurred.

13. The following elements should be considered: (a) timeliness of compensation; (b) asymmetry of accounting disclosure; (c) forgone interest and lower MVA than in other IFIs; and (d) additional compensation.

(a) Timeliness of compensation

14. IFAD expects to be compensated on a "pay-as-you-go" basis for principal repayments as per the underlying amortization schedule that would have been used if the financial resources provided to these countries had been on highly concessional loan terms.

15. IFAD's highly concessional loans are repaid over a 40-year period, including a ten-year grace period. Compensation by Member States would likewise be received over this period. Therefore, while DSF approval began in 2007 with subsequent disbursements, the first principal compensation occurred during IFAD10 (2016-2018). The evident timing gap between DSF approval/disbursement and compensation is generating cash-flow mismatches and accounting asymmetries.

(b) Asymmetry of accounting disclosure

16. In line with International Financial Reporting Standards and industry best practices, DSF financing is recorded as an expense in the statement of comprehensive income (within the annual consolidated financial statements of IFAD) on a yearly basis based on disbursements made, with an immediate negative impact on yearly results and retained earnings. On the other hand, principal compensation is accounted for directly as an equity component when an instrument of contribution is deposited. As a result of the timing gap between disbursements and compensation, as of 31 December 2016 IFAD had accounted for US$805.9 million in yearly costs (disbursements) with a direct negative impact on retained earnings. This was partially compensated by US$2.9 million in pledges received for the DSF thus far. IFAD's retained earnings will decrease sharply in future replenishment periods with the growing impact of DSF. This asymmetry will remain if DSF continues as a form of financing for IFAD. If compensation from Member States is not reasonably assured, there will be impacts on IFAD's liquidity – most immediately seen as a significantly lowered PoLG.

(c) Forgone interest and lower MVA than in other IFIs

17. IFIs ensure DSF compensation on the interest component through the MVA, as described in paragraph 5 of the main report. When applied in the PBAS, MVA reduces the impact of the DSF on up-front flows.

18. Of IFIs reviewed, IDA, AfDB and ADB apply an MVA of 20 per cent while IFAD applies a 5 per cent MVA. For IFAD, this lower percentage results in less compensation for forgone interest than other IFIs.

19. For IDA, the MVA is set at 20 per cent and is redistributed across all PBAS recipient countries.

20. For the AfDF, the forgone income is compensated by an up-front charge on grants. This is based on a redistribution process in which an up-front charge is applied to the grant's allocation. This up-front charge is the result of a discounting process for grant flows. The up-front charge is deducted from the grant allocation in the 20 per cent MVA. For AfDF, the overall grant envelope (of DSF and non-DSF amounts) is initially a grant level of 36.44 per cent. The up-front grant charge is 13.33 per cent and the remaining 6.67 per cent is issued to DSF recipient countries.

[14] IDA's positive rating was primarily a result of its strong equity position, high liquidity and the certainty of commitments from member states to replenish IDA and its debt-relief initiatives.

21. The Asian Development Fund (ADF) also applies a 20 per cent MVA, with some differences in application compared to the AfDF. Of the 20 per cent MVA, 15 per cent is a charges-related portion to cover forgone income and administrative charges, and 7.5 per cent is incentive-related, which is reallocated to all ADF-only and higher-income countries using performance-based allocation shares. It should be noted that ADB has limited exposure to DSF countries.

22. The table below presents the PBAS allocation distribution across financing terms as a result of an MVA at 5 per cent and MVA at 20 per cent.[15]

Table 2
Impact on portfolio of PBAS allocation with MVA at 20 per cent versus current MVA at 5 per cent

Lending terms	*Current model MVA 5%*	*Proposed model MVA 20%*
DSF	**15.8%**	**14.5%**
Highly concessional	35.4%	35.7%
Blend	17.2%	17.5%
Ordinary	31.6%	32.2%
	100%	**100%**

23. The resulting resource flows deriving from a PoLG distribution of financing terms with a 20 per cent MVA would imply higher liquidity and additional interest and principal repayments from countries borrowing on ordinary terms.

(d) Additional compensation

24. Member States have expressed their commitment to compensate the Fund for the DSF principal[16] component. But there is a risk that the amounts originally agreed upon with Member States may not materialize. Moreover, DSF pledges should be additional to replenishment contributions. As per the current methodology agreed upon in a Governing Council resolution, unless it is additionally pledged, DSF compensation is deducted from the overall contribution amount.

25. Paragraph 97(h) of the "Report of the Consultation on the Tenth Replenishment of IFAD's Resources" (GC 38/L4/Rev.1) states that: "Donor contributions made in future replenishments be used to cover DSF obligations first, with any residual balance being considered as regular replenishment contributions…."

26. This mechanism is causing an erosion of replenishment contributions (equity), akin to capital paid by Member States. The replenishment exercise will ultimately not serve to generate fresh resources other than compensating for previous DSF commitments. This negative effect will be even more significant during future replenishment periods as DSF repayment amounts increase.

27. As of 31 December 2016, US$2.2 million had been received against US$2.9 million in pledges made for DSF as part of IFAD10. With a DSF compensation target US$3.4 million, the resulting shortfall of pledges against the target totalled US$500,000 or 14 per cent of the total DSF compensation.

28. Table 3 summarizes the DSF at the end of 2016, including approvals (from 2007 until December 2016), DSF principal compensation foreseen based on the current

[15] As mentioned previously, IFAD applies an MVA of 5 per cent for DSF eligible countries, which is then redistributed to all countries. The 5 per cent discount is applied to individual countries' PBAS allocations. IFAD is currently reviewing its PBAS formula. Since this formula determines how IFAD resources are distributed among Member States, impacting the resulting individual country allocations, any changes to the formula will impact the amount of resources the 5 per cent MVA corresponds to – and its corresponding share in the distribution of financing terms. Table 2 illustrates this by showing the IFAD10 distribution of financing by financing terms with the current MVA and with a 20 per cent MVA. Since the IFAD's PBAS revision is ongoing, the information in table 2 regarding future scenarios is tentative and subject to change.
[16] See footnote 13.

level of approvals, and forgone interest reflows. Noteworthy assumptions used in table 3 include a cut-off date of 31 December 2016 for all DSF commitments approved as of this date (while approvals continue beyond this date, it was established for practical purposes). Given that approvals and activity are determined in SDR, table 3 below is shown in SDR, with the United States dollar equivalent at the SDR-US$ exchange rate as of 31 December 2016.

Table 3
DSF approvals and estimated principal and interest amounts
(Millions of special drawing rights)

Replenishment	Year	Approved	Disbursed/to be disbursed	Principal reflows	Interest (0.75%)	Total principal + interest	Total principal + interest by replenishment
	2007	63.5	1.2		0.01	0.01	
IFAD7	2008	70.4	3.7		0.04	0.04	0.1
	2009	122.5	8.3		0.1	0.1	
	2010	97.3	24.5		0.3	0.3	
IFAD8	2011	135.8	46.5		0.6	0.6	2.1
	2012	203.9	76.4		1.2	1.2	
	2013	92.8	93.5		1.9	1.9	
IFAD9	2014	63.3	103.6		2.7	2.7	7.9
	2015	160.5	89.7		3.4	3.4	
	2016	76.0	89.8		4.0	4.0	
IFAD10	2017		96.3	1.3	4.7	6.0	17.5
	2018		89.8	2.1	5.4	7.5	
	2019		85.2	5.7	6.0	11.7	
IFAD11	2020		78.7	9.7	6.6	16.3	47.2
	2021		76.9	12.0	7.1	19.1	
	2022		44.3	16.6	7.3	23.9	
IFAD12	2023		33.1	23.7	7.4	31.1	88.7
	2024		32.8	26.2	7.5	33.7	
	2025		11.8	29.3	7.4	36.7	
IFAD13	2026			33.7	7.2	40.9	120.4
	2027			35.9	6.9	42.8	
	2028			35.9	6.7	42.5	
IFAD14	2029			35.9	6.4	42.3	126.8
	2030			35.9	6.1	42.0	
	2031			35.9	5.9	41.7	
IFAD15	2032			35.9	5.6	41.5	124.4
	2033			35.9	5.3	41.2	
	2034			35.9	5.1	40.9	
IFAD16	2035			35.9	4.8	40.7	122.0
	2036			35.9	4.5	40.4	
	2037			35.9	4.2	40.1	
IFAD17	2038			35.9	4.0	39.8	119.5
	2039			35.9	3.7	39.6	
	2040			35.9	3.4	39.3	
IFAD18	2041			35.9	3.2	39.0	117.1
	2042			35.9	2.9	38.8	
	2043			35.9	2.6	38.5	
IFAD19	2044			35.9	2.4	38.2	114.7
	2045			35.9	2.1	38.0	
	2046			35.9	1.8	37.7	
IFAD20	2047			35.9	1.6	37.4	110.2
	2048			33.8	1.3	35.1	
	2049			32.7	1.0	33.7	
IFAD21	2050			29.0	0.8	29.8	88.4
	2051			24.3	0.6	24.9	
	2052			19.8	0.4	20.2	
IFAD22	2053			13.2	0.2	13.5	43.8
	2054			9.9	0.1	10.1	
	2055			7.2	0.1	7.3	
IFAD23	2056			2.5	0.0	2.5	9.8
	2057						
	Total SDR (millions)	1 086.0	1 086.0	1 086.1	174.8	1 260.8	1 260.8
	Total US$ (millions)	1 460.4	1 460.4	1 460.4	235.0	1 695.4	1 695.4

29. Table 4 below indicates the increasing erosion of liquidity and replenishment contributions (equity) that will result if the current practice of deducting DSF compensation from overall pledged amounts does not change. As IFAD enters future replenishment periods, the percentage of DSF compensation will increase as a percentage of total pledges; however, the replenishment contributions will decrease as a percentage of pledges.

Table 4
Future DSF compensation and replenishment contributions as percentages of total pledges[17]

Replenishment	*DSF compensation as percentage of total pledges*	*Replenishment contribution as percentage of total pledges*
IFAD11	3.4	96.6
IFAD12	8.3	91.7
IFAD13	11.4	88.6
IFAD14	13.4	86.6
IFAD15	13.0	87.0

30. Annex I provides the pro-rata share among Member States envisaged for the IFAD10, IFAD11 and IFAD12 periods. The increasing burden on Member States is illustrated in table 5 below, which provides the overall DSF compensation targets estimated for future replenishments along with an example of the increasing burden share of DSF contributions for two randomly selected countries (for illustrative purposes only).

Table 5
Increasing burden share amount
(Millions of United States dollars)

Illustrative country	*DSF IFAD10 Target contributions*	*DSF IFAD11 Target contributions*	*DSF IFAD12 Target contributions*
Italy	0.3	2.9	6.9
China	0.1	0.8	2.3
Total per replenishment	**3.4**	**37.0**	**89.5**

[17] Assuming that the DSF continues as per IFAD's current practice of commitments and disbursements beyond 2016. The size of replenishment is estimated as per table 3 amortization analysis and assumptions.

III. Options

31. The alternatives[18] below should be considered, noting that any changes in the current DSF mechanism will be subject to replenishment consultation endorsement and Executive Board and Governing Council approval (an amendment of the Agreement Establishing IFAD may also be needed). The status quo has not been considered a viable option because, based on the examined evidence, Management believes that it is not financially sustainable for IFAD to continue with the DSF framework in its current form.

Option 1: Continue offering DSF financing but harmonize the compensation model with that of other IFIs.

32. This option would allow IFAD to continue providing DSF financing while minimizing the DSF impact on IFAD's resources and ensuring certainty on DSF compensation. This requires:

- Changing the MVA to 20 per cent to ensure interest compensation; and
- Member States reaffirming, enhancing and fully honouring their commitments to make DSF principal repayments in an amount additional to the replenishment targets.

33. This will generate:

- Higher liquidity resulting from higher loan interest and principal repayments from countries with ordinary and blended lending terms (the level of liquidity at the end of IFAD11 is estimated at US$1.12 billion, increasing to US$2.3 billion in 2040);
- In line with the current definition of resources available for commitment based on sustainable cash flows, the resulting PoLG will not be reduced as a result of the additional future cash flows generated (in this scenario, the current estimated a PoLG in IFAD11 is US$3.08 billion, increasing to US$3.89 billion in IFAD15, subject to change);
- Additional DSF principal compensation separate from replenishment resources that is aligned to the percentage of future DSF compensation and replenishment compensation over total pledges (see table 4) – and with certainty in timing and resources, replenishment contributions (equity) will be preserved; and
- The continuation of a valuable financial instrument currently available to qualifying countries.

34. Steps to be taken to apply this option:

- Apply PBAS allocation formula with MVA at 20 per cent consistent with the practice of other IFIs;
- Separate DSF principal compensation and that additional to the replenishment (even if they follow the same process).
- To shore up Member States' commitments to making DSF principal repayments, the IFAD11 Resolution should include wording to this effect, based on the Executive Board's recommendations in its "Review of the status of the Debt Sustainability Framework",[19] which was an annex to the Report of the Consultation on the Tenth Replenishment of IFAD's Resources endorsed by the

[18] The previous analysis within the Working Group on IFAD's Lending Terms to access MDRI financing is not viable since MDRI is a closed facility not available to IFAD.
[19] EB 2013/110/R.31/Rev.2.

IFAD10 Consultation. The proposed text for inclusion in the IFAD11 Resolution should be as shown in annex III.

- Since the Agreement Establishing IFAD does not require the Fund to be compensated for forgone principal reflows resulting from DSF implementation, an amendment of the Agreement Establishing IFAD to address the need for compensation could be considered. Such an amendment would enhance Member States' commitments to make DSF compensation contributions additional to regular replenishment contributions. Amendments to the Agreement Establishing IFAD require a four-fifths majority of the total number of Governing Council votes.

Option 2: Discontinue the DSF as a debt-relief and debt management mechanism from IFAD11 onwards, while ensuring compensation for DSF amounts already approved.

35. Considering the significant impacts on IFAD's financial sustainability if the Fund does not succeed in securing additional, timely DSF compensation, a second option would be to discontinue DSF financing from IFAD11 onwards. With this option:

- Higher liquidity from IFAD11 onwards would result since non-DSF loan reflows would be 100 per cent assured (the level of liquidity at the end of IFAD11 is estimated at US$1.12 billion, increasing to US$2.1 billion in 2040).
- Using a resource definition based on sustainable cash flows, the additional future cash flows generated would result in a PoLG that is not reduced. In this scenario as per current estimates, the PoLG would total US$3.2 billion in IFAD11, increasing to US$4.1 billion in IFAD15, subject to change.
- A valuable financial instrument currently available to qualifying countries would be lost.

36. Without a DSF mechanism, there would be implications for DSF recipient countries, which would no longer receive DSF grant financing. The other option for these countries would be to access loans on a highly concessional basis. A detailed country-by-country analysis has been conducted and discussions would be needed to move these countries to alternative financing arrangements.

37. IFAD is also revising its PBAS methodology, which more strongly reflects the "debt distress" element rather than using the DSF framework. The Multilateral Development Bank Debt Issues Group is revisiting the underlying methodology for the first time since the DSF was introduced. It is too early to determine the impact on IFAD's financial situation of any changes, which may affect its financing terms no earlier than 2019. However, the new strategy also emphasizes the debt distress variable. This means that if these proposals materialize, poorer countries with higher debt distress levels could receive more concessional financing than currently received with the current PBAS methodology. As a result, they would be less dependent on DSF financing as alternative funding sources to IFIs become available, especially bilateral financing.

38. The Fund would have to ensure compensation for commitments already approved up to IFAD11. While financial sustainability would be ensured, it would not be aligned with other IFIs' debt sustainability mechanisms and concessionality.

39. Steps to be taken to apply this option:

- Revise the PBAS allocation formula to discontinue DSF allocations and reallocate funds to highly concessional loans from IFAD11 onwards.
- Seek DSF principal compensation for amounts already approved thus far amounting to SDR 1,086,000,000 (see table 3).
- Discontinue DSF financing in the form of suspension or termination of DSF allocations.

- Termination would require amendments to the Agreement Establishing IFAD and the Policies and Criteria for IFAD Financing in order to remove references to DSF financing contained in these documents. Amendments to the Agreement Establishing IFAD require a four-fifths majority of the total number of Governing Council votes.
- Suspension would require a Governing Council resolution taken by a two-thirds majority of the total number of votes to temporarily discontinue DSF financing.

40. IFAD Management concludes that of the two options considered in this paper, option 1 is the preferred option since it will reduce: (i) the negative overall financial impact on IFAD's resources; (ii) the negative impact on the Fund's capacity to carry out its mandate; and (iii) negative repercussions when IFAD proceeds with a credit rating exercise.

DSF compensation by list and country for IFAD10, IFAD11 and IFAD12

Amounts in millions of United States dollars; US$-SDR exchange rate as of 31 December 2016 for IFAD11 and IFAD12.

List	Country	IFAD10	IFAD11	IFAD12
A	Austria	0.1	0.6	1.9
	Belgium	0.1	1.2	2.9
	Canada	0.2	2.7	6.4
	Denmark	0.1	0.6	1.4
	Finland	0.0	0.7	1.4
	France	0.2	2.0	4.2
	Germany	0.2	2.6	6.3
	Ireland	0.0	0.3	0.7
	Italy	0.3	2.9	6.9
	Japan	0.2	2.2	6.3
	Luxembourg	-	0.1	0.2
	Netherlands	0.2	2.8	6.3
	New Zealand	-	-	0.3
	Norway	0.2	1.7	4.2
	Portugal	-	0.1	-
	Russian Federation	-	-	0.5
	Spain	0.2	2.1	-
	Sweden	0.2	2.1	6.1
	Switzerland	0.1	0.7	2.8
	United Kingdom	0.3	2.4	6.9
	United States	0.3	3.3	7.5
Total list A		**2.8**	**31.0**	**73.3**
B	Algeria	-	0.4	0.8
	Gabon	-	0.01	0.03
	Indonesia	0.03	0.2	0.8
	Iraq	0.01	0.1	-
	Kuwait	0.04	0.4	1.3
	Nigeria	0.03	0.6	1.3
	Qatar	0.1	-	-
	Saudi Arabia	0.1	0.7	1.9
	United Arab Emirates	-	0.04	0.1
	Venezuela (Bolivarian Republic of)	0.1	0.2	
Total list B		**0.3**	**2.6**	**6.2**
C	Angola	-	0.1	0.2
	Argentina	0.01	0.1	0.6
	Bangladesh	-	0.02	0.1
	Botswana	-	-	0.02
	Brazil	0.04	0.5	1.4
	Burkina Faso	-	-	0.01
	Cambodia	-	-	0.02
	Cameroon	-	0.04	0.1
	Chad	-	-	0.03
	China	0.1	0.8	2.3
	Colombia	-	-	0.02
	Congo	-	0.01	-
	Democratic Republic of the Congo	-	-	0.02
	Ecuador	-	-	0.03
	Egypt	0.02	0.1	0.3
	Ghana	-	0.01	0.03
	Guyana	-	0.02	0.1
	India	0.1	0.9	2.5
	Israel	-	-	0.01
	Kazakhstan	-	-	0.04
	Republic of Korea	0.02	0.2	0.6
	Lebanon	-	0.01	-
	Mexico	0.02		0.4
	Morocco	-	0.03	0.1
	Nicaragua	-	-	0.02
	Pakistan	0.02	0.3	0.7
	Paraguay	-	0.02	0.01
	Peru	-	0.01	0.03
	Philippines	-	-	0.02
	Senegal	-	-	0.02
	South Africa	-	0.03	0.04
	Sri Lanka	-	0.04	0.1
	Sudan	-	-	0.02
	Syrian Arab Republic	-	0.02	-
	United Republic of Tanzania	-	-	0.01
	Thailand	-	0.01	0.03
	Tunisia	-	0.02	0.1
	Turkey	-	0.04	0.1
	Uruguay	-	-	0.02
	Viet Nam	-	0.02	0.1
	Yemen	-	0.04	0.1
	Zimbabwe	-	-	0.03
Total List C		**0.3**	**3.4**	**10.0**
Grand total		**3.4**	**37.0**	**89.5**

Methodologies applied by other IFIs

1. Purpose

This section describes the methodologies used by IDA, AfDF and ADF to determine shares to fund principal repayments and compensation contributions. Management conducted this comparison in order to harmonize and adopt best practice to IFAD’s circumstances.

2. International Development Association

At IDA, donor contributions for debt relief and grant compensation are considered additional to regular contributions. Donors are expected to cover 100 per cent of principal repayments forgone as a result of grants by making additional contributions to future replenishments on a pay-as-you-go basis. IDA’s donors provide regular contributions as well as additional contributions to cover costs related to the HIPC Debt Initiative and compensation for forgone principal on grants, the MDRI and DSF compensation. Until IDA17, compensation arrangements for forgone principal on grants on a pay-as-you-go basis were negotiated as a separate replenishment over the three-year commitment period of IDA replenishments. During IDA18, contributions have been kept flat and therefore not negotiated on a singular basis.

3. African Development Fund

For the AfDF, each donor country’s contribution is computed by normalizing its burden share for the replenishment in which grants are being compensated. To ensure that AfDF is fully compensated for grants extended under a specific replenishment, the sum of all donors’ subscriptions must be 100 per cent. Donor subscriptions refer to replenishment pledges corresponding to the period in which the grants were made, as a basis for determining burden shares. For example, grant compensation for AfDF-9 is based on the normalized burden share of all donors that participated in the AfDF-9 replenishment.

Donors compensate the forgone principal reflows on a pay-as-you-go basis. Each year, based on their normalized burden share, they pay into the AfDF what would have been the amount of the reflow had the grant been provided as a loan. When donors do not wish to make a separate pledge for DSF grant compensation, their part of the compensation is subtracted from their total pledge – lowering their basic replenishment contribution and burden share. Donors receive voting rights for all payments made to the AfDF for grant compensation.

AfDF donor compensation for forgone principal repayments on grants was applied to AfDF-12 since this was the first replenishment cycle in which forgone principal repayments on DSF grants would have been due. During the AfDF-9 negotiations, AfDF deputies agreed to finance the forgone principal on a pay-as-you-go basis. In addition, the deputies agreed that the burden share used during the replenishment cycle in which the DSF grants were made would be used to calculate the burden share of member states for DSF compensation.

The MVA reduces a grant eligible country’s allocation by 20 per cent. The MVA has two components:

(i) A charges-related component to offset charges on ADF grants; and

(ii) An incentive to preserve PBAS allocations.

Forgone income is compensated through a forgone up-front charge and the remaining portion is allocated to AfDF-only countries using the PBAS. The up-front charge is computed based on the overall grant level for the three years of the replenishment period and discounted. This is deducted from each grant allocation with the remaining amount allocated to AfDF countries only.

4. Asian Development Fund

The ADF offers donors a choice of two burden-sharing frameworks for the eleventh replenishment (ADF XI):

(i) Adjusted ADF X burden share; or

(ii) ADF X burden share.

The adjusted ADF X burden share was determined based on the total ADF X contributions net of the ADF X financing gap, which resulted in a scaled-up burden share, enabling ADF to receive full compensation from these two items.

While most donors opted for the adjusted ADF X burden share, a few opted for their respective ADF X burden shares for both basic contributions and the two compensation items. The burden share is linked to the ADF X, the replenishment immediately prior to ADF XI (when grants were approved) since compensation in future replenishments involves multiple replenishments. The burden-sharing framework to be adopted for compensation items in the next replenishment (ADF 12) will be subject to donors’ agreement during replenishment negotiations. For the ADF, donors have also agreed to compensate for forgone principal on a pay-as-you-go basis.

Compensation for forgone principal was agreed among donors when the DSF grant provision was introduced under ADF IX, which started in 2005. This agreement was included in the ADF IX donors’ report and the grant framework paper was approved by ADB’s board of directors. The compensation was part of donors’ total contributions for ADF XI (2013-2016).

Proposed text for inclusion in the IFAD11 Resolution

The Member States' commitment to compensate the Fund for principal forgone as a result of DSF implementation is reaffirmed. In addition, it is affirmed that the Fund is to be further compensated for net losses in interest and service charges incurred as a result of the provision of DSF financing. In particular:

(a) Consistent with practices at other International Financial Institutions (IFIs), the pay-as-you-go principle approved by the Executive Board in April 2007 is to be applied in respect to DSF compensation contributions;

(b) DSF beneficiary countries are excluded from the requirement to make a DSF compensation contribution in addition to other forms of additional contributions made on a pay-as-you-go basis;

(c) With the exception of additional contributions received by the Fund in the form of the grant element of a concessional partner loan or an unrestricted complementary contribution, any additional contribution made by a Member State shall, in the first instance, be applied by the Fund in full or partial satisfaction of such Member State's DSF compensation share. Following satisfaction in full of such Member State's DSF compensation share, any remaining amounts of the additional contribution received shall be allocated by the Fund as such Member State's core contribution. The Fund shall apply the foregoing principle notwithstanding any allocations to the contrary that such Member State may have made in connection with the payment of its additional contribution; and

(d) Income forgone (in the form of interest and service charges) as a result of the Fund's extension of DSF grants shall be offset by an up-front volume reduction on DSF grants. This volume reduction shall be implemented by means of a modified volume approach (MVA) mechanism established at a 20 per cent discount rate and redistributed as determined by IFAD Management, taking into consideration the practices of other IFIs and the long-term viability of the Fund.