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Investing in rural people

IFAD's Comprehensive Approach to Transition/Graduation

Addendum to discussion paper

Consultation on the Twelfth Replenishment of IFAD's Resources —
Second Session

Virtual meeting, 16-17 June 2020

For: **Review**

Preamble

1. In formulating IFAD's transition/graduation pillars, it is crucial to recognize its specificities as a development fund. Donor replenishments are IFAD's main source of financing and enable it to continue its operations. A strength of IFAD's financing is that 55 per cent of its Member States contribute to the replenishments. They are the bedrock of the financial architecture that enables IFAD to maximize its contribution to achieving the 2030 Agenda for Sustainable Development. IFAD does not benefit from the same financial flexibility, structures and magnitude to absorb shocks/changes to its financial flows as multilateral development banks. Sustained and increasing financial support from Members in terms of numbers and volumes of pledges are therefore crucial for its success.
2. IFAD proposes four key pillars for its transition/graduation approach. These are aligned with the combination of triggers and indicators already utilized at the World Bank, and also reflect IFAD's ambition to support Member States in sustaining their development pathway and accompany countries towards voluntarily becoming non-borrowing donors.
3. These four pillars of transition/graduation are: (i) distribution of IFAD's financial resources; (ii) financing conditions of borrowed resources; (iii) the trajectory for upper-middle-income countries reaching graduation discussion income threshold; and (iv) addressing reversals due to economic shocks.
4. Management proposes an automatic trigger for the start of the process to review a country's eligibility to access IFAD's financial resources. The outcome of that process will be non-mechanical and will emphasize the importance of dialogue with the country within the framework of the country strategic opportunities programme.
5. Consensus among Member States on these pillars will allow IFAD to be equipped with an adequate, clear and transparent framework to continue delivering on its mandate, while remaining mindful of the different development trajectories of its Members.

I. Introduction

1. Following the first session of the Consultation on the Twelfth Replenishment of IFAD's Resources (IFAD12), Management prepared a discussion paper on IFAD's comprehensive approach to transition/graduation, outlining principles and mechanisms for accessing IFAD's financial resources. This paper was discussed at an informal meeting open to all Member States on 11 May, the outcomes of which were summarized and shared with Members. This addendum builds on feedback regarding the key principles of transition/graduation in the discussion paper which Management has grouped under four pillars in this document.
2. As highlighted by several Member States, a consensus on these key principles will allow IFAD to be equipped with an adequate, clear and transparent policy to deliver on its mandate with the support of its Members – especially in these highly challenging times when the status quo is not an option – in order to contribute more strongly to the 2030 Agenda for Sustainable Development.
3. In section II, Management proposes four pillars of transition/graduation: (i) distribution of IFAD's financial resources; (ii) financing conditions of borrowed resources; (iii) the trajectory for upper-middle-income countries reaching the graduation discussion income threshold; and (iv) addressing reversals due to economic shocks. A way forward in terms of approval by IFAD's governing bodies is proposed in section III.
4. The following updates to the discussion paper are proposed: grouping the key principles into four pillars; providing UMICs with assurances as to the minimum level of allocated resources in IFAD12; adopting an updated and non-mechanical dialogue-based approach to transition including additional criteria over and above the GNIPC, broadly aligned with the World Bank's graduation policy. Further details are provided on the principles for pricing of borrowed resources, and the proposed way forward has been defined more clearly.
5. In order to progress towards reaching consensus among all Members, Management seeks further agreement of Member States on the four key pillars described in section II and on the way forward set forth in section III.

II. Key pillars for consensus by Members

6. Building on the discussion paper, Management has assembled the fundamental elements of transition/graduation under the following four key pillars.

Pillar 1: Distribution of IFAD's financial resources
7. This pillar addresses the eligibility criteria for accessing IFAD's financing, including the minimum and maximum share of IFAD's overall financial resources to be directed to low-income countries (LICs), lower-middle-income countries (LMICs) and upper-middle-income countries (UMICs). The elements described below are interlinked principles for the distribution of IFAD's financial resources and should be considered as elements of one common resource distribution package.
8. **Access to IFAD's overall financial resources.** IFAD Management proposes that only countries classified as LICs, LMICs or UMICs by the World Bank,¹ or those considered eligible for official development assistance (ODA),² be eligible for IFAD financing. High-income or non-ODA eligible countries would not be able to access IFAD's financial resources. It is expected that a country classified as high income has reached a level of institutional development and capital market access that enables it to sustain its own development process without recourse to IFAD's

¹ Management will consider the thresholds and income category classification available at the time of the assessment. Figures presented are indicative.

² In line with the OECD DAC list showing all countries and territories eligible for ODA.

financial resources.³ Countries exceeding this level could continue to access IFAD's non-financial services on a full cost-recovery basis.

9. **Access to core resources.** Management proposes that core resources are allocated in full (100 per cent) to LIC/LMIC borrowers.⁴
10. **Access of UMICs to IFAD's overall resources.** Lending to UMICs would be funded solely from borrowed resources. To ensure an appropriate overall institutional focus, Management would aim to ensure that at least 80 per cent of IFAD's overall financing is provided to LICs/LMICs, and up to 20 per cent is provided to UMICs.⁵
11. The allocation of borrowed resources is expected to be demand-driven; project selectivity criteria will include development effectiveness and creditworthiness.⁶
12. As noted by many Members during the informal meeting, IFAD is in a period of financial transition aimed at ensuring timely and reliable access to borrowed resources from a range of sources on competitive terms. Given this transition, and in order to address the concern of UMICs that there may not be sufficient borrowed resources available in IFAD12, Management proposes the principle of allocating to UMICs in IFAD12 at least the same share of total resources that was allocated to them in IFAD11 (i.e. 11 per cent of the programme of loans and grants).

Pillar 2: Financing conditions of borrowed resources

13. This pillar explains the differentiation in financing conditions for borrowed resources including those provided to countries that have reached the graduation discussion income (GDI) level as established by the International Bank for Reconstruction and Development.⁷
14. This differentiation would allow IFAD to apply appropriate financing conditions for countries experiencing higher levels of economic development, and to continue providing more concessional resources to countries with lower levels of economic development.
15. **Pricing of borrowed resources.** Building on IFAD's current pricing differentiation,⁸ the proposed approach will continue to reflect the diverse economic status of IFAD's borrowers. IFAD will maintain its current pricing methodology based in differentiation by maturity premiums and borrowers' income categories and further reflect the GDI as the threshold of differentiation of financing conditions.
16. Countries that have reached the GDI threshold and continue to have access to IFAD's financial resources would be subject to specific financing conditions that, following the current pricing methodology, will include an increase in the pricing terms.
17. Given the significant level of concessionality embedded in longer maturity of current ordinary term loans,⁹ it is proposed that UMICs will only have access to

³ In IFAD9 and IFAD10, only two of the seven high-income countries eligible for financial resources received an allocation: US\$8 million and US\$6 million respectively. In IFAD11, no high-income countries received an allocation.

⁴ Special provisions are in place for small states and countries with fragile situations eligible for concessional resources.

⁵ Considering the initial scenarios 1 to 5 presented in the IFAD12: Strategic Directions document (IFAD12/1/R.6), resources to UMICs could go from US\$400 million to US\$593 million. These figures were presented during the first Consultation session (February 2020) and are expected to be adjusted depending on the final agreement on the level of replenishment and related financial assumptions (i.e. scenarios of allocation of core and borrowed resources).

⁶ The principles of this mechanism will be included in the business model and financial framework paper to be presented to the Consultation meeting in July, while a detailed proposal on the mechanism for allocating borrowed resources will be presented to the Executive Board. LICs and LMICs that are not in debt distress or high debt distress may also demonstrate demand for borrowed resources.

⁷ IFAD will consider the IBRD-GDI as the key criterion to determine the start of a country's transition/graduation process.

⁸ IFAD is currently applying a pricing methodology for ordinary term loans based on IBRD financing conditions and a maturity premium. In all cases, the GNIpc of borrowers is considered.

⁹ Current ordinary term loan can have a maximum maturity of 35 years and grace period of 10 years without exceeding an average maturity of 20 years.

loans on ordinary terms with shorter maturities. This will mean in effect that LICs and LMICs will receive loans with a higher level of concessionality than UMICs, consistent with their stages of development and income categories.

Pillar 3: Trajectory for UMICs reaching GDI threshold

18. This section explains the process and timeframe for transition/graduation from access to IFAD financing.
19. In response to feedback from Members, this addendum proposes to institutionalize transition/graduation dialogue with countries, using as a basis for such dialogue the country strategic opportunities programme (COSOP) process which already includes a fully-fledged transition strategy process¹⁰ for countries that reach the GDI threshold. This approach would allow for an inclusive process of transition/graduation.
20. **Transition/graduation from access to IFAD financing.** Aligned with the IBRD graduation policy, the key criterion used to determine the start of a transition/graduation process is the achievement of GDI (as defined by the IBRD), which is a proxy for access to adequate capital and strong institutions.¹¹
21. In response to Members' queries as to the automatic or mechanical nature of a transition/graduation process based solely on a financial indicator, Management is proposing the inclusion of the factors used in the IBRD graduation approach, namely: (i) the country's ability to access external capital markets on reasonable terms; and (ii) the country's progress in establishing key institutions for economic and social development; and (iii) to place more emphasis on dialogue with Member States during the transition period through COSOPs and COSOP reviews.
22. Management proposes that countries that have reached the GDI threshold initiate a dialogue that will be reflected in a new COSOP. This discussion would take place on a case-by-case basis reflecting country context. The new COSOP would be presented to the Executive Board for approval within three years of the GDI threshold being reached.¹² During this process, the expected trajectory of the country would be agreed, including the institutional and financial capacities that are expected to be in place, as well as non-lending activities (e.g. reimbursable technical assistance, and South-South and Triangular Cooperation).
23. It is expected that, as income levels rise, lending to countries above the GDI threshold should be a declining trend, barring unforeseen shocks. Management would encourage countries above the threshold to make further efforts to increase their financial contributions to IFAD and move progressively towards becoming non-borrowing donors.¹³

Pillar 4: Addressing reversals due to economic shocks

24. The exceptions applicable in the different cases of reversal are set forth below.
25. **Exceptions for countries sliding back between UMIC and LMIC categories.** The assessment of a country's eligibility for access to core or borrowed resources will take place prior to the start of each replenishment period, in order to ensure the predictability of IFAD's offer. However, any reversal during the replenishment cycle may be considered by IFAD as effective from the beginning of the following financial year, subject to resource availability.

¹⁰ As per IFAD's Operational Procedures and Guidelines for Country Strategies, COSOPs should become fully fledged transition strategies with medium-term programmatic interventions.

¹¹ The IBRD GDI is set at a GNIpc of US\$6,975 as of 1 July 2019. As of May 2020, IFAD borrowers with a GNIpc above this level are: Argentina, Brazil, China, Cuba, Lebanon, the Maldives, Mexico, Montenegro, Turkey and the Bolivarian Republic of Venezuela.

¹² Countries that have already reached the GDI threshold before the adoption of the transition/graduation policy by the Executive Board (which is expected to occur in 2021) should present their new COSOP within 3 years of the approval of the aforementioned policy.

¹³ Management will consider the IBRD's systematic analysis and assessment of the key elements of the IBRD graduation policy, reflected in the Country Partnership Frameworks (CPFs) and Performance Learning Review (PLR).

26. **Exceptions for UMICs sliding back below the GDI threshold.** Any reversal of income to under the GDI during the transition period would delay discussions on transition/graduation from IFAD financial support. In addition, should a country experience a reversal with respect to the criterion above (i.e. a decline in GNIpc to below the GDI threshold) after they have transitioned/graduated from IFAD financial support, they would be eligible to access IFAD's financial resources in the following replenishment period, subject to the approval of the updated COSOP by the Executive Board.
27. **Exceptions for countries sliding back from high-income status to UMIC status with above-threshold GDI.** Any reversal of income categories between HIC and UMIC while the country is expected to remain above the GDI would enable the country concerned to be eligible for IFAD financial support in the following replenishment period, subject to the approval of the updated COSOP by the Executive Board.

III. Way Forward

28. Building on the discussions above on the four pillars, Management proposes:
 - (i) agreement on the pillars and their fundamental elements for transition/graduation as part of the IFAD12 Consultation, and integration of the relevant elements into the IFAD12 Consultation Report, particularly regarding access to IFAD's financial resources in IFAD12;
 - (ii) inclusion of a summary of the overall discussions on transition/graduation as an annex to the IFAD12 Consultation Report; and
 - (iii) Including, as an IFAD12 commitment, the development of a transition/graduation policy to be in place for IFAD12, and submission of said policy to the Executive Board for approval.