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Investing in rural people

COVID-19: Financial Impact and Stress Tests

Note to Consultation members

Focal points:

Dispatch of documentation:

Deirdre Mc Grenra

Chief
Institutional Governance and
Member Relations
Tel.: +39 06 5459 2374
e-mail: gb@ifad.org

Technical questions:

Alvaro Lario

Associate Vice-President
Chief Financial Officer and Chief Controller
Financial Operations Department
Tel.: +39 06 5459 2403
e-mail: a.lario@ifad.org

Ruth Farrant

Director
Financial Management Services Division
Tel.: +39 06 5459 2281
e-mail: r.farrant@ifad.org

Benjamin Powell

Director and Treasurer
Treasury Services Division
Tel.: +39 06 5459 2251
e-mail: b.powell@ifad.org

Advit Nath

Director and Controller
Accounting and Controller's Division
Tel.: +39 06 5459 2829
e-mail: a.nath@ifad.org

Jose Joaquin Morte Molina

Chief Risk Officer
Financial Operations Department
Tel.: +39 06 5459 2561
e-mail: j.mortemolina@ifad.org

Ronald Hartman

Director
Global Engagement, Partnership and
Resource Mobilization Division
Tel.: +39 06 5459 2610
Mob.: +39 331 684 7665
e-mail: r.hartman@ifad.org

Leon Williams

Senior Partnership Officer (Replenishment)
Global Engagement, Partnership and
Resource Mobilization Division
Tel.: +39 06 5459 2809
Mob.: +39 366 783 5759
e-mail: l.williams@ifad.org

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

Rome, 16-17 June 2020

For: **Review**

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I. Background and scope

1. **The COVID-19 pandemic has already had an unprecedented impact on world economies**, global financial flows and international trade, although the depth and breadth of the resulting economic shocks is still unknown. The economic downturn caused by the measures taken to contain the virus has led to higher unemployment, declining global remittances,¹ deteriorating global food security² and a slowdown in public and private investment, and has raised uncertainty around debt servicing in the case of both donors and recipients of official development assistance (ODA).
2. **The response to the crisis has also been unparalleled.** Central banks have provided massive support – in some countries exceeding cumulative backing over the years following the global financial crisis of 2008 – in addition to their discretionary fiscal response. The shock to supply and demand resulting from the crisis is affecting less advanced or emerging economies in particular due to the retraction of capital flows, and the lack of sufficient monetary or fiscal mechanisms. This has called for coordinated and extraordinary support from the international financial community and bilateral agencies.
3. **IFAD, as a development finance institution (DFI), has a vital role** in helping to counter the effects of the crisis. In line with other DFIs, IFAD is taking targeted actions tailored to each Member State's context. In addition to the swift creation of the Rural Poor Stimulus Facility these have included repositioning ongoing programmes and establishing remote arrangements to keep the portfolio in full operational flow, while upholding quality standards and fiduciary oversight.
4. **IFAD's borrowing challenges could be exacerbated in the context of COVID-19.** As an overarching principle, IFAD shares a common reality with other DFIs: its financial ability to respond to this crisis is dependent on continuous and extraordinary financial support from Member States, especially given IFAD's structure as a replenishment fund. As a result, the encashment of Member State replenishment contributions and loan reflows (i.e. repayments of outstanding loans coming due) are, and remain, IFAD's core resources and the bedrock of its capital structure.
5. **On the other hand, borrowing is key for IFAD** to deliver its growing programme in light of the stagnating trend in ODA, which emerged well before the COVID crisis. IFAD can currently borrow only through loans by sovereign states and their institutions. This represents a challenge, as the availability of funds from these counterparts tends to follow ODA trends. An integrated borrowing framework (IBF) is being introduced to broaden sources of funding and instruments. In the meantime, however, IFAD's short-term funding and liquidity levels were already under pressure prior to the pandemic. As outlined below, the COVID crisis could exacerbate the difficulties faced by IFAD in raising new borrowing, especially in the absence of adequate support from Member States and a successful credit rating exercise.
6. **The milestones reached so far to strengthen IFAD's financial resilience and sustainability need to be preserved.** During the last two years, IFAD has made continuous significant enhancements to its financial profile and risk management, which will strengthen its position over the next decade. The Debt Sustainability Framework (DSF) reform, the Capital Adequacy Policy, the Asset Liability Management Framework, the updated lending terms and the approach to the new Liquidity Policy are all fundamental tools to preserve not only IFAD's capital and

¹ The World Bank reported an expected drop of global remittances in 2020 of US\$445 billion, or 19.7 per cent, to low-income countries (LICs) and lower middle-income countries (LMICs). The World Bank estimates that remittances to LMICs will recover in 2021, rising by 5.6 per cent to US\$470 billion.

² According to a statement made by the International Labour Organization (ILO) "Over time, workers in this sector may be increasingly impacted, particularly if the virus spreads further into rural areas".

liquidity, but indeed the long-term viability of the institution. Further key initiatives that are to materialize in the near future, including the completion of the credit rating process, the introduction of the IBF, the accelerated repayments and voluntary prepayments framework – and, in particular, finalization of the new Liquidity Policy – are all aimed at strengthening IFAD’s capacity to absorb losses and play a countercyclical role by being able not only to weather unexpected economic shocks but also provide extraordinary financial support to its borrowers.

7. IFAD is sharpening its focus on risk evaluation, reporting and mitigation by implementing a holistic enterprise risk management strategy across the organization, supported by strengthening the enterprise risk management function to coordinate such efforts.
8. **The purpose of this document is to present Members with an overview of the possible financial impact of the COVID-19 pandemic on the Eleventh and Twelfth Replenishment of IFAD’s Resources (IFAD11 and IFAD12).** IFAD’s financial profile, capacity to deliver on IFAD11 and IFAD12 and the credit rating process are all interlinked. Outlined below are, first, the possible impact of COVID-19 on IFAD’s financial profile and second, three scenarios prepared in response to concerns and uncertainties raised by Executive Board representatives. The decisions that IFAD and its Members could be called upon to make, should extreme events materialize, could have long-term repercussions on the organization and should therefore be carefully evaluated, in order to not revert to an unsustainable trajectory.
9. **This analysis does not forecast the likelihood of any of these events.** Rather, it focuses on the potential impact on IFAD and Management’s proposed response. During the IFAD12 Consultation session to be held in July, Management will present five updated replenishment scenarios in a document titled “business model and financial framework 2022-2024”.³

II. COVID-19 financial impact

10. Over the past decade IFAD has faced increased financial challenges due to unprecedented growth in the volume of its programme of loans and grants (PoLG) (including DSF grants), the frontloading of loan approvals and accelerating loan disbursements, all while replenishment contributions have remained stagnant. This pandemic will affect the economies of both borrowers and donors. IFAD’s current ability to borrow is limited, and the COVID-19 shock could further exacerbate the financial challenges faced to date.
11. IFAD is a replenishment fund with no access to public capital markets. Sources of short-term funding are mainly: (i) the encashment of contributions; (ii) the timely repayment of reflows by borrowers; and (iii) sovereign loans. IFAD can currently rely on a limited pool of sovereign lenders whose priorities and availability of funds is positively correlated with ODA availability. Securing funding from sovereign lenders and their agencies could become more difficult in light of emerging priorities in their own countries as a result of COVID-19.
12. **The encashment of contributions and loan reflows in IFAD11 might also be impacted.** The other two major funding sources for IFAD from Member States could also be affected by the current global economic challenges, as explained below. Some countries may also face deteriorating debt sustainability exacerbated by the COVID-19 pandemic, leading to a need for additional support from IFAD in the form of DSF grants.
13. The following paragraphs present the link between the COVID-19 economic shocks and IFAD’s financial profile:

³ The five IFAD12 replenishment scenarios include replenishment targets of US\$0.95 billion (very low); US\$1.15 billion (low); US\$1.35 billion (mid-low); US\$1.55 billion (mid-high); and US\$1.75 billion (high).

- (i) Replenishment contributions from Members remain the primary funding source for IFAD. Delays in the encashment of contributions due to the crisis could have a serious impact on funding and liquidity. For the remainder of the IFAD11 period, encashments are expected to be approximately US\$550 million; this is key to meeting IFAD's disbursement commitments for 2020 and 2021. Around 86 per cent of these encashments are to come from IFAD's top 10 contributors and Management is counting on their continued timely support. However, delays could materialize in the remaining 14 per cent, most likely in 2020, from countries experiencing serious economic difficulties.⁴
- (ii) Loan reflows are the largest internal funding source for IFAD, amounting to an approximate US\$800 million to be encashed in 2020 and 2021. IFAD's loan portfolio is well diversified, and exposure to the 10 largest borrowers corresponds to just under half of the portfolio. Although Management does not expect to see continued financial issues in most of the top 10 countries, a failure of some reflows to materialize would have an impact not only on liquidity but also on the level of non-performing loans (NPLs).⁵ That level stood at 2.7 per cent as of end-2019, and could increase significantly over the next 12 or 18 months. Any such increase in arrears would have a significant impact on IFAD's deployable capital and preferred creditor status.⁶
- (iii) Signing of sovereign loans: During the IFAD11 period, IFAD requires an estimated additional amount of borrowing of up to US\$500 million to reach the IFAD11 targets of PoLG and disbursements while maintaining liquidity levels. A positive credit rating is key to securing the needed borrowing, and could be jeopardized by a lack of Member support under a stress scenario. The success of the credit rating exercise is fundamental to secure the amounts needed for IFAD11 and IFAD12 on sustainable financial conditions. The repercussions of COVID-related stresses on IFAD's finances, without a strong signal of support from Members, would most likely jeopardize the rating process. Furthermore, a good rating remains the key enabler for full implementation of the IBF.
14. Since IFAD is expected to reach its minimum liquidity requirement by 2021, liquidity shocks from any of the above occurrences – if not offset by additional funding or a reduction in outflows – would result in a breach of the liquidity policy. IFAD would then need to adjust disbursements and other expenses accordingly to remain above the minimum liquidity requirement. Inadequate levels of liquidity could entail a reputational risk for a financial institution such as IFAD.
15. **Mix of loans and grants.** The current financing terms for IFAD's borrowers were approved in 2019. In the event of economic reversals in income categories, however, IFAD would need to apply more concessional terms for 2021 approvals to those borrowers. Since the start of the pandemic, the International Monetary Fund (IMF) has been issuing updated debt sustainability assessments (DSAs) to reflect additional potential shocks on countries' economic outlooks. To date, updated DSAs have been issued for 24 of the 40 DSF-eligible countries with IFAD11 performance-based allocation system (PBAS) allocations, which have all confirmed the original traffic light colour of debt distress assessments.⁷ Based on these assessments and

⁴ Contributions could also be impacted by currency risk. With about 25 per cent of contributions receivable in non-United States dollar currencies, these payments will continue to pose an open currency position for IFAD. Given the strength of the United States dollar at the beginning of the crisis and in the absence of a hedging strategy, the degree of certainty that the amount actually received matches the amount pledged is lower than before the crisis.

⁵ Non-performing loans are loans with amounts overdue for more than 180 days. For these loans, interest and service charges are not recognized on an accrual basis. They are recognized as income only when actually received.

⁶ Preferred creditor status is a widely accepted principle whereby multilateral development banks (MDBs) and other DFIs such as IFAD are given priority for repayment of debt in the event of a borrower experiencing financial stress. Rating agencies assess the preferred creditor status based on the institution's past and present arrears experience.

⁷ As part of MDB coordination, IFAD's Management reached out to other DFIs and regional MDBs to review with them their forecasts for debt sustainability assessment changes.

considering the frontloading of a large part of IFAD11 approvals in 2019 and 2020, with no retroactive change in lending terms, Management is currently not expecting additional costs due to debt distress for countries in the IFAD11 forecasts.

III. Selected stress scenarios

16. In this section, Management presents three extreme scenarios and related impact in response to concerns and uncertainties raised by the Executive Board representatives. The analysis highlights the impact on IFAD's financial sustainability. IFAD's financial trajectory is deemed to be unsustainable when, as a result of an existing or potential scenario, and in the absence of sufficient fresh capital injection, current and future projections of liquidity are lowered (less borrowing, reflows and/or contributions) to such an extent that it lacks the capacity to disburse according to existing targets, or deployable capital is forecasted to decrease below zero. Under such an event, disbursement targets would be substantially reduced so as not to deplete liquidity in the short term and the future PoLG would be bound to decline, to ensure that existing commitments can be honoured.
17. The three stress tests are as follows:
 - (i) Reduced access to borrowing;
 - (ii) More countries falling into the DSF category of high indebtedness, i.e. becoming "red countries" entitled to DSF grant financing rather than loans; and
 - (iii) Debt moratorium or debt relief without full compensation from donors.
18. The expected COVID-19 financial shock is included in the stress test figures and the detailed assumptions underlying the stress tests are found in annex II. The selected stresses are not independent, although we have simulated the outcomes independently. In principle, reduced access to borrowing can realistically be expected to happen also in the case of the two other events; in either of the two, if the necessary support from Members were to be lacking, the credit rating process could be jeopardized and it is reasonable to assume that funding and borrowing availability for IFAD would also be negatively impacted.
19. Table 1 summarizes the high-level consequences of the stress tests. The document further elaborates on the consequences on various levels (financial, strategic, operational and reputational) as well as Management's recommended position for Members' consideration.

Table 1

Stress test summary of the IFAD12 US\$1.15 billion replenishment scenario

	Description of stress	Financial sustainability	Estimated IFAD12 PoLG	Reputational risk
Reduced access to borrowing	Borrowing decreased to 25 per cent of total, from US\$1.2 billion- US\$1.4 billion to US\$325 million	Yes At lower PoLG levels and affecting disbursement capacity. Replenishment only source of growth	US\$1.7 billion Any growth will depend on increased borrowing	Medium to high (need to adjust pace of disbursements)
More countries in DSF + undoing DSF reform	Additional 11 countries in DSF, from US\$340 million to US\$681 million and IFAD does not comply with DSF reform	No Liquidity and capital will be depleted with inability to meet existing commitments on a timely basis	US\$1.5 billion In a rapid downward spiral afterwards	Very high (inability to meet existing commitments with recipient countries on a timely basis)
Debt moratorium or debt relief without compensation	Postponement or cancellation of reflows due in 2020 - 2021 by 100 per cent LICs (US\$180 million) and 25 per cent LMICs (US\$100 million)	No IFAD's survival and sustainability depends on Members' support and adjustment to its business model	US\$0 - US\$1.0 billion (affecting IFAD11 PoLG and IFAD's ability to disburse at same pace)	Very high (change in IFAD's business model and need to adjust pace of disbursements)

20. **Considering IFAD's efforts to evolve towards a more sophisticated and financially sound institution, the following main conclusions can be drawn:**

- (i) Management does not recommend participation in a debt moratorium or relief unless full and timely compensation from Member States is secured.
- (ii) Management does not recommend allocation of additional DSF resources without full adherence to the DSF mechanism reform by Member States, whereby any increase in grant approvals is contingent upon additional full upfront funding through increased donor contributions.
- (iii) Management notes the importance of donor support as part of a successful credit rating process, which will enhance IFAD's ability to access higher volumes of borrowed resources at more competitive pricing.

21. If IFAD were to subvert the DSF reform or participate in a debt moratorium without compensation, this would place it on an unsustainable trajectory. It would have a negative snowball effect on IFAD's reputational risk and a negative impact on the credit rating outcome. This would certainly affect IFAD's ability to mobilize both core and borrowed resources. As a consequence, the IFAD12 PoLG would be severely affected and IFAD's ability to support poor rural beneficiaries would be reduced dramatically.

IV. Reduced access to borrowing

22. For IFAD12, expected borrowing is estimated at between US\$1.2 billion and US\$1.4 billion. This stress scenario analyses the consequences of accessing only 25 per cent of that amount. Such a scenario would be consistent with access to a reduced number of potential lenders or an unsuccessful outcome of the credit rating exercise in IFAD11. For illustrative purposes, it is assumed that IFAD would be able to borrow only US\$325 million, with an assumed split between US\$225 million in concessional partner loans (CPLs) and US\$100 million in the form of less concessional sovereign loans.

23. Under such a scenario, IFAD would still be sustainable. However, to ensure a sustainable trajectory and assuming the same lower level of borrowing in the future, all future POLGs would be expected to be up to a maximum of US\$1.7 billion. This assumes that IFAD would still have limited access to increased borrowing in IFAD13 and IFAD14.
24. Resources would need to be redirected primarily to honour existing commitments for loan and grant disbursements. The disbursement commitments related to approvals from IFAD8 to IFAD11 falling due in IFAD12 are expected to amount to US\$2.80 billion over the period 2022-2024. The pace of disbursements would need to be adjusted accordingly, exposing IFAD to some degree of reputational risk.
25. A second effect would be on the composition of the PoLG with reduced borrowing. IFAD's loans would have to be funded primarily from reflows, thereby also reducing core resources and the capacity to provide grant financing. Under such a scenario, Management would propose that all resources continue to be allocated through PBAS with a reduced envelope for all income categories.
26. Under the current PBAS and given that resources are formula-driven, Management would not be able to commit to any minimum allocation for upper-middle-income countries. All income categories would unquestionably see a reduced volume of resources, with a major impact on the LICs and LMICs that are major recipients of IFAD's loans.

V. Additional countries eligible for DSF grants

27. Given current trends in debt management, this stress test foresees that at least some of the countries that are currently in moderate debt distress would fall into high debt distress and therefore be entitled to receive DSF grants.
28. In line with the DSF reform approved by the Executive Board in December 2019,⁸ IFAD's maximum grant capacity would be predetermined, based on replenishment contributions from Member States, to avoid returning to an unsustainable trajectory. Next, we analyse what would happen to DSF grant recipients under the DSF reform as agreed in December 2019, and study the hypothetical consequences if IFAD were not to apply the DSF reform.
29. If the DSF reform is adhered to and we assume a low replenishment scenario of US\$1.15 billion, the maximum sustainable DSF grant level would be US\$ 340 million, and the mix of loans and grants in the PoLG in terms of size would not change. If the total grant size is the same but the number of countries eligible for DSF grants increases, the grant allocations for individual DSF-eligible countries would decrease as a result. The pool of loans from the remainder of PBAS resources would then be allocated mainly to the remaining LIC and LMIC loan borrowers. IFAD would still be able to support a large number of LICs and LMICs with substantial programmes, but only with highly concessional loans.
30. For illustrative purposes and to quantify such an effect, Management simulates a very strong negative shock whereby countries assessed by the IMF as being in moderate risk of debt distress, with limited and some space to absorb shocks, would be downgraded to a high debt distress status. This would translate into an additional 11 countries entitled to DSF grant financing, amounting to US\$340 million, for a total DSF grant eligibility of US\$681 million – double the amount in the IFAD12 baseline of this scenario. While the financial impact of additional DSF grants is ring-fenced through the pre-financing mechanism of the DSF reform, the eligibility of additional countries would lead to a reduction in the grant allocations of individual countries of up to 47 per cent.

⁸ Debt Sustainability Reform (document EB 2019/128/R.44), approved by the Executive Board at its 128th session in December 2019 and the Governing Council at its 44th session in February 2020.

31. Under a more extreme stress test, if Executive Board representatives were to request that IFAD approve DSF grants beyond the maximum sustainable capacity level of a given replenishment, this would mean reverting to an unsustainable trend and unwinding one of IFAD's key financial architecture reforms. It would create a snowball effect whereby IFAD would continue to erode capital and liquidity.
32. The first obvious consequence would be a loss of access to borrowing, since IFAD would not be able to obtain a positive credit rating. Under such a scenario, IFAD would also be using a large part of its reflows to fund the additional DSF grants, which would diminish any future reflows and therefore programmes, thus curtailing IFAD's future operating capacity. The reduction in future reflows due to countries receiving grants rather than loans would also make IFAD more dependent on new replenishments just to disburse the current approved projects, and would allow for no additional financing to programme new activities, thus reducing reflows even further.
33. Next, we simulate the impact on the PoLG going forward if the Executive Board were to approve such an unsustainable amount. From the previous discussion and for illustrative purposes, we assume the same level of DSF grant eligibility, that is, US\$681 million of the US\$1.15 billion low replenishment scenario. If IFAD were to grant this increased additional grant financing without affecting its future capacity to continue with its current disbursements, the new PoLG trajectory for IFAD12 would need to be US\$1.5 billion. Assuming that IFAD continues to provide these countries with the same amounts in IFAD13, this would result in a PoLG below US\$1 billion in IFAD13. From IFAD14 onwards, IFAD would not be able to support future programming, and would only be able to disburse on programmes already approved in IFAD10, IFAD11, IFAD12 and IFAD13. Under such a scenario, the pace of disbursements would need to slow dramatically in order for the institution to be able to absorb the flows with decreasing loan reflows and very small net replenishment increases, which would not permit the creation of any additional loans. This scenario would expose IFAD to a very high reputational risk.
34. Over a number of replenishment cycles, all new reflows would be needed to cover approved disbursements, and ordinary loan reflows would be used to repay IFAD's debts. The multiplier effect of being a financial institution with access to borrowing would no longer exist and IFAD would effectively cease to operate as a going concern. The decreased development impact and the impact on millions of rural people would be tremendous.
35. In line with the Executive Board decision on DSF reform, Management recommends not providing DSF grant financing above IFAD's financial capacity to do so, to avoid falling back into an unsustainable trajectory.

VI. Debt moratorium for 2020 and 2021 or debt relief without compensation from donors

36. A debt moratorium implies allowing borrowers to delay repayments of outstanding loans for a given time frame, to be recovered over a specified period of time in the future. Debt relief implies cancelling the borrowers' debt outright.
37. Management is closely monitoring collective responses by multilateral development banks (MDBs) and international financial institutions to assist countries in difficulty. G20 nations have agreed to freeze bilateral government loan repayments for low-income countries until the end of 2020, as part of a plan to tackle the health and economic crises triggered by the coronavirus pandemic and prevent an emerging markets debt crunch.
38. The interaction between borrowers, creditors, credit rating agencies and international capital markets is complex. MDBs have been asked to explore participation as long as it does not impact their financial health and credit ratings in

a way that diminished future lending. It is also possible that credit rating agencies may penalize borrowers who participate in debt relief by downgrading their credit rating and therefore reducing their access to international capital markets going forward.

39. In coordination with other actors, IFAD stands ready to participate in any coordinated international agreement and support its borrowers to the best of its ability. However, Management has stressed that IFAD will only be in a position to participate in a debt relief initiative if full legally binding and timely compensation from Member States is ensured. In this case, the effect on IFAD's capital and liquidity would be neutral and the Members' support under extraordinary circumstances would be extremely beneficial for IFAD's reputation, mandate and credit rating process.
40. Even considering the very low probability of such an event, some Members have asked about the financial effect of such a process. Under an extreme scenario, Management simulates the financial consequences for IFAD of a postponement of up to 18 months (in the case of a moratorium) or a full cancellation (in the case of relief) of reflows due in 2020 and 2021 by 100 per cent of LICs and 25 per cent of LMICs. This would amount to approximately US\$180 million for LICs and approximately US\$100 million for LMICs. These figures are quantified to produce the outcome of such an event but do not reflect the likelihood of such an event occurring.
41. Full compensation by the Member States would signal fundamental support by IFAD's main donors for its mission to external stakeholders such as lenders, borrowers or credit rating agencies. This would be considered an important championing of IFAD's role in the international development architecture under these very extraordinary circumstances. Timing would also be a major consideration.
42. In the absence of additional support from Member States, the impact of these two hypothetical initiatives would be similar. As a financial institution, this approach would create uncertainty about the robustness of IFAD's current loan portfolio and balance sheet valuation by external auditors and credit rating agencies. The financial impact would extend well beyond the US\$280 million in debt relief in 2020 and 2021 to affect the assessment of IFAD's proven track record of preferred creditor status, with a potential impact on key credit metrics (i.e. probability of default). Conversations with both auditors and credit rating agencies have made it clear that such a debt moratorium without financial support would create uncertainty and potentially have a very negative effect on the assessment of the credit quality of IFAD's loan portfolio.
43. Outlined below is an account of projected financial and strategic consequences:

Financial consequences: unsustainable trajectory

- (i) **Liquidity** – According to the resources available for commitment document,⁹ IFAD's liquidity level before the COVID-19 crisis was expected to be around US\$715 million at end-2021, updated to US\$793 million in more recent base-case projections. Should Covid-19 shocks materialize, IFAD's liquidity could fall below the minimum liquidity requirement by the end of 2021, potentially to US\$500 million against a minimum liquidity requirement of US\$700 million. In the case of a moratorium, this would be a temporary shock, while it would be a permanent one in the case of debt relief.

A second effect of such an occurrence would be potentially to jeopardize the success of IFAD's credit rating process in two ways. First, liquidity is a crucial factor for assessing the financial strength of an institution, and liquidity levels that cannot cover the following nine to 12 months disbursements would most

⁹ EB 2019/128/R.37.

likely be considered as “adequate”, rather than the “strong” or “very strong” liquidity assessments issued for institutions rated AA and AAA. Second, the absence of compensation from donors would be judged as a lack of Member State support for the institution, another key variable for a successful credit rating. Going forward, IFAD will ensure that the new liquidity policy will provide for sufficient liquidity to enable it to play a countercyclical role and support countries when they are most in need.¹⁰

- (ii) **Recognition of losses** – As indicated above, in addition to the liquidity shock, debt relief would imply the immediate recognition of losses, increasing IFAD’s chronic financial deficit and therefore affecting the capital base and the financial capacity to realize the PoLG for IFAD11.
- (iii) **Recognition of NPLs**– In the absence of full compensation, a massive moratorium on repayments or suspension of debt beyond 180 days would impact the impaired loan ratio. The simulation exercise considers only relief for 2020 and 2021, but many of these countries would still have repayments to IFAD falling due from 2022 onwards. IFAD would need to reclassify the total outstanding amount of these loans and might need to account for the entire amount of the country’s debt to IFAD as non-performing. This would have commensurate consequences from an accounting and capitalization perspective depending on the percentage of non-performing loans – which could rise to an unprecedented level among international development institutions and affect IFAD’s capacity to fund the remainder of the IFAD11 programme.

Strategic consequences: PoLG, reputational risk, moral hazard, policy importance and preferred creditor status

- (iv) **Effect on PoLG** – Subject to the final assessment by IFAD’s external auditors in terms of accounting treatment, these scenarios would have an impact on IFAD’s capital by immediately reducing both its capital base and deployable capital. IFAD would need to focus on the repayment of its existing debt (CPLs and sovereign borrowings) and would be cut off from external financing sources other than donor contributions for an indefinite period of time. It would likely also have to suspend new operations in order to earmark all new resources exclusively to cover current commitments of US\$5.7 billion of approved undisbursed loans and grants. Under such a scenario, one possible outcome is that IFAD would need to slow or suspend IFAD11 PoLG approvals pending further clarity on the consequences.
- (v) **Reputational risk** – In the absence of full compensation, any of the proposed scenarios would send a clear negative signal to external stakeholders as to the importance of IFAD’s mission for Member States. The consequences for IFAD’s current financial prospects and the rating process would be severe. Any prospective lender to IFAD, with or without a credit rating, would interpret this as IFAD’s major donors placing little weight on the institution’s long-term sustainability. It would create not only financial risk but also reputational risk. It would certainly limit IFAD’s borrowing options, and a number of borrowers might also feel legitimized in delaying repayments to IFAD.
- (vi) **Moral hazard and policy importance** – Any attempt to provide debt moratorium or debt relief without compensation might also create a problem of moral hazard in the selection of countries. It might also imply a deviation

¹⁰ To understand the magnitude of IFAD’s flexibility, it is important to note that current yearly disbursements range between US\$900 million and US\$1 billion, whereas yearly disbursements averaged only US\$400 million as recently as IFAD9. Given IFAD’s current liquidity levels versus expected approved undisbursed loans, this would affect all Member States in terms of both current disbursements and future financing capacity. The impact would be especially marked for the LICs and LMICs that are the major recipients of IFAD’s funding.

from or non-compliance with existing policies, hence affecting IFAD's operating profile.

(vii) **Preferred creditor status** – Either of the two possibilities would affect the so-called cornerstone of a development financial institution's credit profile: preferred creditor status. This is one of the key principles underlying the strength of the business model and financing capacity of international financial institutions (combined with callable capital for MDBs). Preferred credit status essentially means that the institutions concerned never cancel or reschedule loans unless they are compensated to do so. It is a principle factored into the qualitative and quantitative assessments performed by lenders and credit rating agencies. A NPL ratio above 10 per cent would certainly diminish IFAD's potential to reach a high credit rating, limiting its capacity to access borrowing at a cost consistent with its development mandate. Moreover, even if this event were considered a one-time event, the consequences would last for at least 10 years, which is the standard economic cycle utilized to assess preferred creditor status.

44. Given the dire consequences of participating in a debt moratorium or debt relief exercise without full compensation, Management concludes that the uncertainties and financial consequences of doing so without fully compensation would outweigh any potential short-term benefits to IFAD's borrowing countries.

VII. Conclusions and way forward

45. **IFAD's mission to support countries and rural communities affected by the COVID-19 crisis is crucial.** IFAD's future ability to continue serving these communities will rely more than ever on achieving a strong IFAD12 replenishment. IFAD's financial challenges are being addressed through a set of financial reforms initiated in the last two years, which have set a foundation of financial discipline and sustainability.
46. Although the COVID-19 shocks intensify the financial challenges faced in the short term, Management will continue to enhance IFAD's financial instruments so that the institution is well positioned to serve its rural communities under any external shocks. IFAD will continue to introduce policy reforms to strengthen its financial profile and play a countercyclical role. IFAD will continue to enhance its funding and liquidity profile through its new Liquidity Policy, the IBF and the accelerated repayments and voluntary prepayments framework. Management stresses the importance of maintaining the current sustainable trajectory and not taking any measures that could compromise the effectiveness of its financial reforms.
47. **The extreme scenarios outlined here highlight the crucial role of Member State support.** While IFAD's short term funding and liquidity levels were already under pressure prior to the pandemic, the COVID-19 shock could exacerbate the current difficulties in raising borrowing, especially in the absence of full support from Member States and successful completion of the credit rating exercise. Without financial and strategic support from its Member States, IFAD's access to additional financing and hence its development impact would diminish rapidly.
48. **These stress tests evidence how certain measures would have a direct adverse impact on beneficiary countries.** The results of the stress tests demonstrate that, in the short run, a lack of support from Member States for IFAD to respond to the crisis could initiate a snowball effect – with an adverse impact on not only IFAD11 but also IFAD12, in terms of net assets, level of PoLG, capital adequacy levels, ability to raise additional financing and meet ongoing commitments including disbursements.

49. **With the support of its Member States, IFAD stands ready to act in alignment with coordinated initiatives of the international development community only if full and timely compensation from Members is secured.** IFAD is funded by replenishments, and replenishment contributions remain the main source of financing underwriting its ability to continue operations. It does not have the same scale or financial flexibility to absorb shocks or changes to its financial flows as other MDBs. Replenishment and loan reflows, as the main constituents of core resources, are paramount to its ability to serve the target populations. IFAD stands ready to support its beneficiaries to the best of its ability. It can only do so, however, with the unequivocal support of its Member States.
50. **Due to COVID-19 economic shocks, more LICs may become eligible for DSF grant financing.** Therefore, it is essential to stress that IFAD's grant financing capacity and ability to operate in LIC countries is linked one-to-one to the financial support that IFAD donor countries provide. Increased allocations to highly indebted LICs on grant terms, as well as to non-highly indebted LICs on loan terms, depend on IFAD obtaining such resources. If the replenishment target remains at current levels, with more countries eligible for DSF grants, country allocations would have to be reduced to remain sustainable. This would mean a significant shift in allocations for LICs and LMICs from grants to loans on concessional terms.
51. **Replenishment contributions are the only resource IFAD can mobilize to continue supporting LICs in high debt distress.** These countries typically suffer from high food insecurity and have little flexibility in accessing additional debt financing on affordable terms. Borrowing remains an important additional funding source, but in order to avoid mission drift, borrowing cannot become IFAD's primary source of financing at the expense of lowering grant capacity.

Revised IFAD12: low replenishment scenario US\$1.15 billion

1. Table 1 below shows the revised IFAD12 scenario resulting from the anticipated short term shocks to funding during IFAD11:
 - (i) Encashment of contributions during IFAD11: assumed to be reduced by US\$40 million to US\$50 million, based on an estimate of countries most affected by the crisis.
 - (ii) Level of borrowing for IFAD11: reduced to US\$300 million from US\$500 million, based on a conservative estimate of funding options for IFAD11 available as at May 2020.
 - (iii) Loan reflows during IFAD11: reduced by US\$80 million to US\$100 million, based on a conservative estimate under the current uncertain global economic situation.
 - (iv) Deployable capital: additional consumption of 2 per cent due to the assumed credit deterioration of the loan portfolio. This is still below the 10 per cent buffer included in the Capital Adequacy Policy.

Table 1

IFAD12 with the low replenishment scenario of US\$1.15 billion

	New IFAD12
Replenishment	US\$1.15 billion
PoLG	US\$2.9-US\$3.1 billion
Total grants (maximum sustainable DSF)	US\$390 million (US\$340 million)
New debt	US\$1.1-US\$1.3 billion
Debt/equity	25%-30%
Deployable capital	22%-17%

2. As shown in table 1, as a result of forgone inflows in IFAD11 the new IFAD12 PoLG is reduced by between US\$200 and US\$400 million compared to the ranges included in the document IFAD12: Strategic Directions.¹¹ This reduction in PoLG would take place as a carry-forward effect of the reduced cash inflow in IFAD11 detailed above, including the shortfall on the IFAD11 replenishment target.
3. Not only the absolute size of the PoLG but also its composition would be affected: assuming new replenishment as per the low scenario of US\$1.15 billion, in line with the sustainable replenishment baseline concept, IFAD would still be able to finance a maximum grant size of US\$390 million and to cover its administrative expenses. Of this total grant size, Management proposes to use a minimum of US\$50 million for regular grants. Support to the most indebted countries, especially LICs, would be unchanged at a maximum level of US\$340 million. Should the number of countries eligible for DSF grant financing in IFAD12 increase, this would result in reduced country allocations and therefore in reduced country impact, specifically for the lowest income borrowers.
4. The reduction in the IFAD12 PoLG would affect all other IFAD borrowers across the entire income spectrum. In addition, a longer-term effect on IFAD's financial position would arise from reduced reflows, resulting from the combined effect of: a higher percentage of grants in the PoLG, and the same amount of borrowed resources (US\$1.1 billion to US\$1.2 billion) to sustain this lower PoLG. The amount of loans funded by IFAD's core resources would fall, as would future reflows, negatively affecting IFAD's commitment capacity.

¹¹ IFAD12/1/R.6.

Assumptions for selected stress test scenarios

	<i>Base IFAD12 scenario used: US\$1.1 billion replenishment scenario</i>		
	<i>Stress scenario 1 moratorium/write-off</i>	<i>Stress scenario 2 additional DSF</i>	<i>Stress scenario 3 reduced borrowing</i>
Replenishment target (new cash contributions plus grant element of CPLs)	US\$1.15 billion	US\$1.15 billion	US\$1.15 billion
Sustainable replenishment baseline (new cash not including grant element of CPLs)	US\$1.1 billion	US\$1.1 billion	US\$1.1 billion
Stress on contributions in IFAD11 compensated in IFAD12	<i>Reduction</i> US\$42 million	<i>Reduction</i> US\$42 million	<i>Reduction</i> US\$42 million
Estimated grant element of CPLs	US\$50 million	US\$50 million	US\$50 million
Time horizon	The scenarios are presented for IFAD12 only. Note: scenario assumptions apply for a time horizon of three replenishment cycles: from IFAD12 up to IFAD14 (2030). Scenario cash flows are projected over 40 years.		
Past DSF compensation	Carved out sustainable replenishment baseline for an amount of US\$93 million		
Gross replenishment level growth rate	1 per cent per year		
Liquidity	Minimum liquidity requirement defined as 60 per cent of gross annual outflows		
Maximum sustainable new DSF grants	US\$340 million	US\$681 million	US\$340 million
Regular grants	US\$50 million	US\$50 million	US\$50 million
CPLs	US\$225 million split into three tranches of US\$75 million per year Grant element estimated with discount rates with market rates as at 29 February 2020 CPL terms estimated at 50 per cent mirroring IFAD highly concessional terms and 50 per cent IFAD blend terms		
Sovereign borrowing (millions of United States dollars)	100	100	100
	Sovereign borrowing terms estimated at financial terms mirroring existing IFAD sovereign loans		

Base IFAD12 scenario used: US\$1.1 billion replenishment scenario									
	Stress scenario 1 <i>moratorium/write-off</i>	Stress scenario 2 <i>additional DSF</i>	Stress scenario 3 <i>reduced borrowing</i>						
Reflows	<p><i>Reduction US\$180 million from LICs</i></p> <p><i>Reduction US\$100 million from LMICs – total US\$280 million less in reflows starting in July 2020 for 18 months</i></p>	<p><i>- Reduction US\$81 million in IFAD11 (split 36/45 in 2020/2021)</i></p>	<p><i>- Reduction US\$81 million in IFAD11 (split 36/45 in 2020/2021)</i></p>						
Disbursement ratio in IFAD12	15 per cent	15 per cent	15 per cent						
Resource allocation	Sovereign borrowing is fully allocated to ordinary terms loans								
Resource allocation assumptions	<p>1. The list of countries receiving IFAD financing is based on IFAD11 LICs, LMICs (66 countries);</p> <p>2. No money is allocated through PBAS to ordinary terms upper-middle-income countries as per IFAD11 lending terms;</p> <p>3. US\$100 million of borrowed resources are allocated through PBAS;</p> <p>4. Resources are allocated through two different pools using the current PBAS formula, as follows:</p> <table border="1" data-bbox="786 874 2018 975"> <thead> <tr> <th><i>Pool A = non-DSF countries – 46 countries</i></th> <th><i>Pool B = DSF countries – 20 countries</i></th> <th><i>Total resources distributed through PBAS – 66 countries</i></th> </tr> </thead> <tbody> <tr> <td><i>US\$1 935 million</i></td> <td><i>US\$340 million</i></td> <td><i>US\$2 275 million</i></td> </tr> </tbody> </table> <p>5. The PBAS formula variables, exponents and coefficients remain unchanged, and the values for the variables of the PBAS formula are those of year 1 IFAD11;</p> <p>6. The rules for minimum and maximum allocations remain unchanged for the overall set of countries (pools A and B have the same maximum, equivalent to 5 per cent of pool A + pool B, and minimum country allocation = US\$1.5 million per year);</p> <p>7. No Management capping is applied;</p> <p>8. Income categories reflect the World Bank classification for fiscal year 2020 (July 2019-June 2020);</p> <p>9. Core resources composition is as follows: replenishment contributions; full CPL amounts; reflows; results from investments.</p>			<i>Pool A = non-DSF countries – 46 countries</i>	<i>Pool B = DSF countries – 20 countries</i>	<i>Total resources distributed through PBAS – 66 countries</i>	<i>US\$1 935 million</i>	<i>US\$340 million</i>	<i>US\$2 275 million</i>
<i>Pool A = non-DSF countries – 46 countries</i>	<i>Pool B = DSF countries – 20 countries</i>	<i>Total resources distributed through PBAS – 66 countries</i>							
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