

Document: IFAD12/3/support documentation
Date: 18 October 2020
Distribution: Public
Original: English

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Investing in rural people

Technical Note on Early Encashment of Replenishment Contributions

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

Rome, 19-21 October 2020

For: **Review**

A. Background

1. At previous sessions of the Consultation on the Twelfth Replenishment of IFAD's Resources (IFAD12), IFAD was requested to explore the possibility of a potential accelerated encashment of contributions for the IFAD12 cycle.
2. A brief analysis has been conducted, including a review of IFAD's existing policies pertaining to the encashment of replenishment contributions, the Fund's experience to date, and comparable practice at other international financial institutions (IFIs) (the International Development Association [IDA] and the African Development Fund [ADF]).
3. IFAD's encashment profile, usually three years (i.e. within a replenishment period), is already accelerated in comparison to other IFIs such as IDA, where contributions are encashed over longer time periods.
4. Generally, IFAD Member States pay their replenishment contributions within three years.
5. An accelerated encashment in the form of one lump sum payment would imply a discount on the nominal value of the contribution in comparison to IFAD's standard encashment profile.
6. Considering the nature of replenishment contributions (i.e. equity), the reference discount rate for early replenishment encashments made in one lump sum payment would be linked to liquidity portfolio investment returns.
7. It should be noted that considering the short time frame and current foreseen market conditions, the discount to be provided would be minimal (for additional details please refer to the simulation contained in the document).
8. Lastly, the accelerated encashment will not modify the current methodology for allocation of voting rights, meaning that voting rights only accrue on replenishment contributions paid to the Fund.

B. IFAD policy on encashment of contributions

9. IFAD's standard encashment schedule for replenishment contributions has been regulated over the years by replenishment resolutions; generally replenishment contributions are paid in three years, within the related replenishment period.
10. In particular, the IFAD11 Resolution (para. 20), in line with resolutions from previous replenishment cycles, provides as follows:

"Payment of contributions

20. Unqualified contributions

- (a) **Payment of instalments.** Each contributing Member shall, at its option, pay its unqualified contribution in a single sum or in two or a maximum of three instalments within the replenishment period. Instalment payments in respect of each unqualified contribution may, at the option of the Member, be made either in equal amounts or in progressively graduated amounts, with the first instalment amounting to at least 30 per cent of the contribution, the second instalment amounting to at least 35 per cent and the third instalment, if any, covering the remaining balance.
- (b) **Payment dates**
 - (i) **Single-sum payment.** Payment in a single sum shall be due on the sixtieth day after the Member's instrument of contribution enters into effect.
 - (ii) **Instalment payments.** Payments in instalments shall be made according to the following schedule: the first instalment shall be

due on the first anniversary of the adoption of this Resolution; the second instalment shall be due on the second anniversary of the adoption of this Resolution and any further instalment shall be due no later than the third anniversary of the adoption of this Resolution. However, if the date of effectiveness has not occurred by the first anniversary of the adoption of this Resolution, the first payment shall be due on the sixtieth day after the Member's instrument of contribution enters into effect; the second instalment shall be due on the first anniversary of the effective date of the Replenishment and any further instalment shall be due on the earlier of the third anniversary of the effective date of the Replenishment or the last day of the replenishment period.

- (c) **Early payment.** Any Member may pay its contribution on dates earlier than those specified in paragraph 20(b) above.
- (d) **Alternative arrangements.** The President may, upon the request of a Member, agree to a variation in the prescribed payment dates, percentages, or number of instalments of the contribution, provided that such a variation shall not adversely affect the operational needs of the Fund."

C. IFAD's experience

- 11. While they have the possibility to pay their contributions earlier than the dates specified in the resolution as per paragraph 21(c), Member States usually pay their replenishment contributions within the relevant replenishment period in a maximum of three instalments or in a single tranche.
- 12. Longer encashments are an exception to be authorized by the President.¹ For IFAD12 contributions, a discount would be applied against the relevant Member State's outstanding contribution arrears, if any.

D. Voting rights

- 13. According to the Agreement Establishing IFAD, only contributions in cash, promissory notes, obligations payable on demand or the grant element of concessional partner loans are considered additional contributions to the resources of IFAD – i.e. replenishment contributions – and give rise to voting rights upon payment.
- 14. The Agreement Establishing IFAD therefore does not allow for the possibility of attaching voting rights to any portion of the discount that would be applied to an early encashment, since such amount is not paid to IFAD.

E. Experience of other IFIs: the example of IDA

- 15. IDA's standard encashment schedule is relatively long (typically nine years). It is defined in the context of each replenishment (see annex I for IDA19), unlike the practice at IFAD where the schedule is ad hoc, on a donor-by-donor basis, and normally restricted to the three years of the replenishment period.
- 16. Most other IFIs follow different funding paradigms and thus do not have similar policies pertaining to the encashment of replenishment contributions. However, ADF has such a policy. ADF's encashment period and methodology are in line with those of IDA.
- 17. In the case of a donor's accelerated payment of contributions against the schedule, the amount to be paid is calculated by discounting the cash flows with a set discount rate, established for each replenishment.

¹ In the zero draft IFAD12 Resolution, it is proposed that the maximum of three instalments be removed, and that each Member State be allowed to pay its unqualified contribution in a single sum or in instalments within the replenishment period.

18. The IDA discount rate methodology (discount applied against arrears) is summarized below.
 - Up to IDA17, the discount rate was based purely on an assumption of investment returns over the nine-year encashment horizon of the standard encashment schedule. In IDA16 it was set at 2.5 per cent, and in IDA17 it was 2.0 per cent. For IFAD, this would mean estimating the investment return over the IFAD-specific time horizon of the three-year encashment schedule.
 - Since IDA18, the methodology to set the discount rate has been changed to the cost of funding. For IDA18 therefore, the discount rate was 0.6 per cent and for IDA19 it was 1.3 per cent.
19. In the case of ADF, the discount rate is calculated using the Overnight Index Swap rate for the accelerated encashment, based on the donor's desired payment schedule.

F. Possible accelerated encashment at IFAD – key considerations

20. Applying the IDA logic, it is important to note that IFAD's standard encashment schedule (three years) is much shorter than IDA's (nine years). It is therefore important to simulate and quantify the benefit of such an option.
21. While it is understood that receiving cash earlier helps IFAD liquidity levels in the short term and adds flexibility to the planning of borrowing in IFAD12, any form of discount (even if applied against outstanding arrears) may be seen as reducing nominal payments. However, on a discounted cash flow basis, this is a financially neutral transaction.
22. In order to proceed, this proposal would need to be discussed during the IFAD12 Consultation sessions, obtain endorsement from all Member States, and, if agreed, be reflected in the IFAD Resolution.
23. There are no specific counter indications from a financial standpoint regarding the payment of contributions in one lump sum. There are, however, hurdles related to the limited time frame for discussing, approving and implementing this item during the IFAD12 Consultation as specified above. Nonetheless, IFAD stands ready to support this modification of its payment mechanisms.

G. Simulation

24. IFAD ran simulations of an accelerated encashment of contributions based on a hypothetical pledge of US\$100 million, encashed according to the standard IFAD schedule over 3 years (30 per cent, 35 per cent and 35 per cent respectively).
25. Because the proceeds of early encashment of contributions would be invested in IFAD's investment portfolio, the discount rate would reflect a projected rate of return attributable to the portfolio of investments at the time of early encashment.
26. The net present value (NPV) can be calculated assuming either payments in advance or payments in arrears for each year (see annex II for details of the methodology used for the discounted cash flow [DCF] calculation).
27. The discounted amount was calculated with the assumptions above, using a discount factor of 0.32 per cent, and assuming annual payments in advance.

Scenario	Nominal value	Discount rate %	NPV value	Discount value	Discount over nominal value %
Annual payments in advance	US\$100 000 000	0.32	US\$99 665 428	US\$334 572	0.33

28. Because of the short horizon and foreseen market conditions, the value of discount would be low.
29. Such discount would be allocated towards the Member's outstanding contribution arrears from previous replenishments, if any.

H. Conclusion

30. IFAD welcomes the request for the possibility of an accelerated encashment of contributions for Member States in IFAD12.
31. Depending on the results of the discussion, it would be necessary to ensure the possibility for all Member States to obtain a discount for early encashment. The discount would be applied against contribution arrears in the next version of the IFAD12 Resolution. Furthermore, the resolution could provide that Management be delegated to develop a formula to calculate the suitable discount rate, which could then be submitted to the Executive Board for review.

IDA19 encashment of contributions schedule

(Extracts from the Report from the Executive Directors of the International Development Association to the Board of Governors Additions to IDA Resources: Nineteenth Replenishment IDA19: Ten Years to 2030: Growth, People, Resilience)²

“187. **Partner grant contributions, if provided in the form of notes, will be encashed on an approximately pro rata basis among Partners following the agreed regular encashment schedule (Attachment II of the IDA19 Resolution).** Partners may, with the agreement of Management, adjust their grant encashments to reflect their legal and budgetary requirements. Deputies agreed to indicate any special preferences in this regard to Management when Partners deposit their Instruments of Commitment. Deputies recognized that the timing of encashments affects IDA’s resource base. They agreed that in exceptional cases, should unavoidable delays occur, IDA’s grant encashment requests to the relevant Partner may be adjusted to take into account any past payment delays by that Partner and any related lost income to IDA. IDA may also agree with any Partner on a revised grant encashment schedule that yields at least an equivalent value to IDA. A Partner’s voting rights will be affected if the net present value is not maintained. Deputies agreed that the present value of Partners’ grant encashment schedules will be based on a 1.3 percent per annum discount rate. Partners that accelerate their grant encashments can use the additional resources as a credit item, either to increase their own regular burden share, to cover a share of their costs under the MDRI replenishment, or to cover a portion of payment arrears from previous replenishments. If a Partner uses their acceleration of the grant encashment to increase their regular burden share, that Partner will receive additional subscription votes on account of the additional resources provided to IDA from accelerated grant encashment. Partners that use accelerated grant encashment can alternatively benefit from a discount on the amounts encashed.”

Annex 13, attachment II:

Encashment Schedule for IDA19 Contributions (Percent of Total Contributions)

<u>Fiscal Year</u>	<u>Standard Schedule</u>
2021	3.1
2022	7.7
2023	13.5
2024	15.6
2025	15.8
2026	14.2
2027	12.6
2028	10.2
2029	7.3
	100.0

² <http://documents.worldbank.org/curated/en/459531582153485508/pdf/Additions-to-IDA-Resources-Nineteenth-Replenishment-Ten-Years-to-2030-Growth-People-Resilience.pdf>.

Methodology for the discount calculation

The IFAD schedule of payment provides the breakdown of contribution payments in a maximum of three instalments.

	Year 1	Year 2	Year 3	Total
Percentage of payments	30	35	35	100

Assuming IFAD12 contributions of US\$100 million, the following deemed payment distribution was obtained.

	Year 1	Year 2	Year 3	Total
Percentage of payments	30	35	35	100
Deemed payments for IFAD12	US\$30 000 000	US\$35 000 000	US\$35 000 000	US\$100 000 000

For simplicity, it was assumed that payments are made in advance at the beginning of each year.

The discount factor is aligned to the absolute return of IFAD investment portfolio. The most updated year-to-date return as of the 2 October 2020 is 0.32 per cent.

From the input above, a scenario was produced showing discounted cash flows calculated in advance for each year.

Scenario	Nominal value	Discount rate %	NPV value	Discount value	Discount over nominal value %
Annual payments in advance	US\$100 000 000	0.32	US\$99 665 428	US\$334 572	0.33

For the NPV calculations, the Microsoft Excel NPV formula was used:

$$\text{NPV} = (\text{rate}, \text{value 1}, \text{value 2}, \dots, \text{value n})$$

By default, the formula calculates the NPV assuming payments in arrears.

In order to simulate payments in advance, the NPV for year 2 and year 3 (12-month discount period for the former and 24-month for the latter) was calculated and year 1 at face value was added. Details of cash flow are shown in the table below.

DCF in advance	
Year 1	US\$30 000 000
Year 2	US\$34 888 357
Year 3	US\$34 777 071
Total	US\$99 665 428