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**IFAD**

**INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT**

**Consultation on the Sixth Replenishment of IFAD's Resources – Third Session**

Rome, 2-3 July 2002

# ADVANCE COMMITMENT AUTHORITY IN THE INTERNATIONAL DEVELOPMENT ASSOCIATION (IDA) AND THE ASIAN DEVELOPMENT FUND (ASDF)

## Introduction

1. International financial institutions (IFIs) typically provide eligible member states with loans that are repaid on a fixed schedule. The loans are disbursed over an extended period, usually about eight years in the case of the International Development Association (IDA) and IFAD. It is therefore accepted that for an IFI to make a loan commitment, the essential requirement is the ability to finance the disbursements as required over the eight-year period. To make a USD 10 million loan commitment, for example, it is necessary is to be able to cover annual disbursements of USD 1.25 million over the eight years, rather than to have the USD 10 million in hand when making the initial commitment.

2. In the early years of IDA, the Asian Development Fund (AsDF) and IFAD, the available resources came principally from donor contributions. In these circumstances, loan commitments could only be made from assured donor contributions. As IFIs matured, however, they developed significant loan portfolios, which now generate substantial reflows in terms of repayments of principal and interest/service charges. These reflows are remarkably robust and stable. In the case of IFAD for example, arrears on repayments currently stand at only 3.1% of the amount due. Four special-case countries, Cuba, Democratic Republic of The Congo, Liberia and Somalia, account for about 80% of the arrears. The other IFAD borrowing states — more than 100 countries — thus have a repayment record of over 99%.

3. The size and stability of loan reflows encouraged IDA member states to establish in 1988 an Advance Commitment Scheme that allowed IDA to make lending commitments against future reflows.

4. This initiative was followed by the Asian Development Fund during the 1990s, when a similar facility to make commitments against future reflows was established by its member states.

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5. Following these initiatives, IFAD's Member States agreed in 1997 to establish the Advance Commitment Authority (ACA), which would allow the institution to use future reflows to make current commitments in a similar way. In IFAD, the procedures for ACA use are decided on a replenishment basis; the Governing Council has authorized the Executive Board to decide on the volume of ACA use.

6. The present note describes how the advance commitment scheme is used in IDA and AsDF. These descriptions are based on inputs kindly provided and verified by these institutions.

**IDA's Advance Commitment Scheme**

7. Until the mid-1980s, IDA did not have substantial reflow levels and made new lending commitments only on the basis of donor contributions and net transfers from the International Bank for Reconstruction and Development (IBRD). Since its 1988 fiscal year, however, IDA has been authorized to use an advance commitment scheme through which it can make lending commitments against future reflows, using the reflows to meet disbursement requirements arising from the commitments.

8. IDA utilizes a financial- and risk-management programme that takes into account its financial structure, cash inflows and outflows. Cash inflows include encashment of donor contributions, loan repayments and service charges, investment income and transfers from IBRD. Outflows include disbursements, administrative expenses and debt relief for heavily indebted poor countries (HIPCs).

9. IDA receives more than USD 1 billion per year in repayments of principal. Over the next decade, repayments are expected to amount to USD 20 billion. The institution uses a financial projections model to generate medium- and long-term projections of cash flow. The model provides an analytical basis for financial risk and investment management and for determining the level of advance commitment that can be used during each replenishment period.

10. In this process, assumptions are made regarding future lending levels, future donor contributions, disbursement profiles, investment returns and major risks relating to such factors as investment income, currency management and liquidity. In particular, the IDA financial model assumes an investment return of 5% per year. A baseline cashflow/liquidity projection is derived on the basis of the assumptions, together with an analysis of their sensitivity and volatility and the consequent minimum level of liquidity required. The projection period is medium-term, with an eleven-year minimum, which represents the disbursement period of the current replenishment commitments. Simulations are then prepared of sustainable levels of commitment against expected internal resources, mainly reflows, in ways that guarantee coverage of the additional disbursements by the expected reflows while maintaining liquidity at a prudent minimum level. This minimum level is estimated at four months of disbursement requirements.

11. A set of core assumptions has been developed in consultation with IDA member states, the most more important of which are:

- stable future lending levels in real terms;
- stable future donor contributions in nominal terms;
- investment returns on the basis of a conservative assumption of expected future returns;
- future repayments on the basis of past arrears;
- cost of participation by IDA in the debt initiative for HIPC to be fully covered by IBRD transfers and additional donor contributions; and
- IBRD net income transfers to IDA to continue at the current volume.

12. The gap to be covered by advance commitment for the replenishment period is derived on the basis of these assumptions, particularly those regarding future lending levels and donor contributions. The advance commitment required must be lower than the sustainable level of commitment authority against projected internal resources. Assuming this is the case, a commitment authority framework is prepared for the replenishment period. The expectation is that the advance commitment utilized will increase in each future replenishment period.

13. For the IDA 12 period, reflows through the advance commitment scheme supported more than 5 billion special drawing rights (SDR) of IDA lending. For the IDA 13 period, IDA is proposing to use more than SDR 7 billion, largely on the basis of future reflows through the advance commitment scheme. SDR 7 billion represents the maximum sustainable use of the advance commitment for the IDA 13 period and the intention is to use it fully for making commitments during IDA 13. To put this in context, IDA currently receives more than USD 1 billion of loan principal repayments.

**Asian Development Fund (AsDF)**

14. The Asian Development Fund employs another form of advance commitment under the Extended Advance Commitment Authority (EACA). Commitments under EACA are additional to commitments based on donor contributions. EACA follows principles and methodology similar to the IDA advance commitment scheme in calculating sustainable use.

15. In AsDF, EACA involves matching future reflows with disbursements. The highest sustainable level of advance commitments is the level that will keep annual disbursements within the projected level of reflows and maintain liquidity in any year above an acceptable minimum. Risks are taken into account in a way similar to IDA; in particular, a reduction is made to allow for arrears in reflows.

16. Under the EACA scheme, calculation of sustainable advance commitment capacity is based on the holdings in the non-donor pool, which holds loan reflows, investment income and other net income, and projected future reflows into the pool over the succeeding twelve years. The level of sustainability of new EACA commitments is determined by matching new commitment streams with the disbursement streams that these commitments generate, while taking account of cash outflows arising from disbursements from past EACA commitments and ensuring that liquidity is maintained at an adequate minimum level.

17. Once the maximum sustainable use of EACA has been determined at the beginning of the replenishment period, the aim is to increase the level of EACA over successive replenishment periods. The intention is to make EACA the main instrument for generating commitment authority for AsDF.

18. Commitments under the EACA are maintained at the same level in each year of the four-year replenishment period. It is recognized that excessive use of EACA in the current replenishment period would reduce the EACA availability in future periods. The level of its use in the current replenishment period is therefore determined through an iterative process to select commitment levels that meet operational resource requirements while ensuring that EACA use can increase monotonically, that is in each successive future replenishment period. In this regard, the planning period for the use of the EACA in AsDF is twelve years.

**Illustrative Application of IDA's ACA Approach to IFAD**

19. The implications for IFAD of IDA/ACA methodology are illustrated in the resource scenario at the end of this document. It incorporates the assumption of a Sixth Replenishment 25% higher than the Fifth Replenishment, with the increase maintained in real terms in subsequent replenishments. It also incorporates the conservative investment income assumption of 3.5% and the same inflation and other assumptions of Scenario G in document REPL.VI/3/R.3. In this scenario, however, the highest level of ACA use has been estimated through an iterative process that ensures that liquidity — the investment portfolio — does not fall below USD 900 million, the minimum level required to finance at least two years of disbursements.

20. This level is far higher than the minimum liquidity level applied by IDA, which is equal to four months of disbursements.

21. The Programme of Work is not predetermined, but is allowed to vary. On these assumptions, sustainable use of ACA in IFAD until 2018 would be between USD 150 million and USD 170 million per year. The Programme of Work during the Sixth Replenishment period would be USD 565 million in 2004 dollars. In the subsequent replenishment period, the commitment level would increase to USD 610 million in 2007 dollars and continue to increase in real terms in subsequent periods.

22. As a result of increased use of ACA, the investment portfolio is projected to decline from USD 2 031 million at the beginning of 2004 to USD 1 056 million in 2018. It should be noted that the investment income assumed for this projection is the conservative level of 3.5%. IDA, for example, assumes 5% per year. In the medium term, however, IFAD's investment portfolio asset allocation is expected to generate an investment return of about 5%.

23. If such a higher return is realized on average between now and 2018, this would increase the Fund's resources by about USD 300 million, and so the investment portfolio in 2018 would be around USD 1.3 billion. Moreover, in IDA there is an understanding with member states that the cost of its participation in the enhanced HIPC Debt Initiative would be financed entirely from IBRD contributions or from additional donor funding. If similar additional funding was made available to IFAD for the amount of its participation in the Debt Initiative for HIPCs, which up to 2018 totals an estimated USD 370 million, the Fund's liquidity position would improve by an equivalent amount.

24. Depending on the assumptions made, the investment portfolio would continue to decline beyond 2018, reaching a minimum of USD 924 million in 2024 before starting to rise again. Calculations relating to these distant periods are somewhat theoretical. The situation would of course be reviewed at the beginning of each replenishment period; adjustments could certainly be made in later years as appropriate. It may therefore be more relevant to focus on the next three replenishment periods, a timeframe comparable to that used by IDA. Over the Sixth, Seventh and Eighth Replenishment periods, ACA use of about USD 170 million per year is sustainable. The investment portfolio would be above USD 1.4 billion – almost equal to three years of disbursement requirements – even assuming a conservative 3.5% investment income.

**Summary**

25. Applying the IDA model would allow IFAD to utilize ACA at an annual level of about USD 170 million through the Sixth, Seventh and Eighth Replenishment periods while prudently maintaining liquidity at over USD 1.4 billion. This is nearly equal to three years' disbursements and is far higher than the IDA benchmark. It is in line with the liquidity level suggested by the Expert Group on Investment Policy. With a 25% increase in the Sixth Replenishment as compared to the Fifth, maintained thereafter in real terms, the IDA/ACA model would allow IFAD to have an annual Programme of Work of USD 565 million, in 2004 dollars, during the Sixth Replenishment period. It would also allow the Fund to increase the Programme of Work in real terms in subsequent replenishment periods.

**Scenario: Replenishment – USD 560 million, ACA use – USD 160-170 million per annum**
**Replenishments: future replenishments USD 560 million at 2004 prices**
**Investment income: 3.5% per annum**
**Commitment level: USD 565 million in 2004 and adjusted upward at each new replenishment period**
**Inflation: 2%**

**Figures in USD million**

| | | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **Resource position** | | | | | | | | | | | |
| 1 | Loan and grant commitments (including some grants now formally under PDFF) | 450 | 450 | 565 | 576 | 588 | 610 | 622 | 635 | 667 | 680 | 694 |
| 2 | PDFF (excluding grants covered under loan and grant commitments * | 14 | 14 | 15 | 15 | 16 | 16 | 16 | 17 | 17 | 17 | 18 |
| 3 | Costs for the Debt Initiative for HIPCs | 15 | 27 | 35 | 37 | 35 | 33 | 30 | 26 | 27 | 23 | 20 |
| 4 | Administrative expenses | 42 | 44 | 49 | 50 | 51 | 52 | 53 | 54 | 55 | 56 | 57 |
| 5 | Extra-budgetary items (Strategic Change Programme and After Service Medical Coverage) | 10 | 14 | 6 | 1 | 1 | 0 | 0 | 0 | 0 | 0 | 0 |
| **6** | **Total annual requirements (expenditures and commitments)** | **531** | **549** | **670** | **679** | **690** | **711** | **721** | **731** | **766** | **777** | **789** |
| 7 | Lending reflows | 180 | 180 | 191 | 198 | 206 | 219 | 232 | 252 | 272 | 283 | 300 |
| 8 | Debt initiative contributions | 4 | 4 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 9 | Loan and grant cancellations (unspent balances) | 50 | 50 | 50 | 50 | 50 | 50 | 50 | 50 | 50 | 50 | 50 |
| 10 | Residual past and present replenishments | 155 | 155 | | | | | | | | | |
| 11 | Investment income | 71 | 74 | 75 | 73 | 70 | 67 | 65 | 63 | 60 | 58 | 55 |
| 12 | Resources available before further replenishment | 460 | 463 | 317 | 321 | 326 | 336 | 347 | 364 | 382 | 391 | 406 |
| **13** | **Assumed future replenishment** | | | **187** | **187** | **187** | **198** | **198** | **198** | **210** | **210** | **210** |
| **14** | **Total resources with future replenishment** | **460** | **463** | **503** | **508** | **513** | **534** | **545** | **562** | **592** | **601** | **616** |
| **15** | **(+) Annual savings/ (-) shortfall-ACA used** | **-70** | **-86** | **-167** | **-172** | **-177** | **-177** | **-176** | **-169** | **-174** | **-175** | **-173** |
| **16** | **Investment portfolio (end year)** | **1 974** | **2 031** | **1 992** | **1 914** | **1 817** | **1 759** | **1 689** | **1 608** | **1 549** | **1 480** | **1 403** |

* To give a clear picture of volume and trends in annual commitment levels consistent with the past, grants now under the Programme Development Financing Facility (PDFF) continue to be reported as loan and grant commitments in these tables.

**Scenario: Replenishment – USD 560 million, ACA use – USD 160-170 per annum**
**Replenishments: future replenishments USD 560 milion in 2004 prices**
**Investment Income: 3.5% per annum**
**Commitment level: USD 565 million in 2004 and adjusted upward at each new replenishment period**
**Inflation: 2%**

**Figures in USD million**

| | | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **Financial position** | | | | | | | | | | | |
| | **Cash inflows** | | | | | | | | | | | |
| 1 | Investment income | 71 | 74 | 75 | 73 | 70 | 67 | 65 | 63 | 60 | 58 | 55 |
| 2 | Net lending reflows (net of HIPC costs) | 169 | 157 | 157 | 161 | 171 | 186 | 202 | 226 | 245 | 260 | 280 |
| 3 | Drawdown from contributions | 269 | 265 | 199 | 187 | 187 | 198 | 198 | 198 | 210 | 210 | 210 |
| **4** | **Total inflows** | **509** | **496** | **430** | **421** | **428** | **451** | **465** | **486** | **515** | **528** | **546** |
| | **Cash outflows** | | | | | | | | | | | |
| 5 | Disbursements (loans and grants) | 358 | 354 | 385 | 417 | 442 | 425 | 449 | 480 | 486 | 507 | 530 |
| 6 | PDFF (including project development costs formerly under the grant programme) | 27 | 27 | 30 | 31 | 32 | 32 | 33 | 33 | 34 | 35 | 36 |
| 7 | Administrative expenses (including extra-budgetary) | 52 | 58 | 55 | 51 | 52 | 52 | 53 | 54 | 55 | 56 | 57 |
| **8** | **Total outflows** | **437** | **439** | **470** | **499** | **525** | **509** | **535** | **568** | **575** | **597** | **623** |
| | **Asset holdings** | | | | | | | | | | | |
| 9 | Investment portfolio (end year) | 1 974 | 2 031 | 1 992 | 1 914 | 1 817 | 1 759 | 1 689 | 1 608 | 1 549 | 1 480 | 1 403 |
| 10 | Promissory note holdings (end year) | 122 | 12 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **11** | **Total assets** | **2 096** | **2 043** | **1 992** | **1 914** | **1 817** | **1 759** | **1 689** | **1 608** | **1 549** | **1 480** | **1 403** |
| | **Risk monitoring indicators** | | | | | | | | | | | |
| 12 | Net cash inflow (total inflows - total outflows) | 71 | 57 | -40 | -78 | -97 | -58 | -69 | -81 | -59 | -69 | -77 |
| 13 | Growth of investment portfolio | | 2.9% | -1.9% | -3.9% | -5.1% | -3.2% | -3.9% | -4.8% | -3.7% | -4.5% | -5.2% |