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Enabling poor rural people to overcome poverty

IFAD's Eighth Replenishment – financial scenarios

Consultation on the Eighth Replenishment of IFAD's Resources – Third Session
Rome, 8-9 July 2008

For: **Review**

Note to Consultation members

This document is submitted for review by the Consultation on the Eighth Replenishment of IFAD Resources.

To make the best use of time available at Consultation sessions, members are invited to contact the following focal point with any technical questions about this document before the session:

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Contents

Glossary

Advance commitment authority (ACA)

Under ACA, IFAD is allowed to use future loan reflows as a basis for making commitments for loans and grants, which is a practice also adopted by the World Bank and other international financial institutions.

Committable resources

Committable resources include only the actual payments received in the form of cash or promissory notes. The value of instruments of contribution against which payment in the form of cash or promissory notes has not yet been made is excluded from committable resources (paragraph 15(b)(i), EB 34 minutes [1988]).

Debt Sustainability Framework (DSF)

The joint World Bank-International Monetary Fund (IMF) framework aimed at supporting low-income countries' efforts to achieve their development goals without creating future debt problems. International financial institutions use the World Bank-IMF assessment of the risk of external debt distress to determine the share of grants and loans in their assistance to each low-income country.

Heavily Indebted Poor Countries (HIPC) Debt Initiative

The HIPC Debt Initiative was launched in 1996 to address the concern that poor countries' debts were stifling poverty reduction efforts. The Initiative calls for voluntary provision of debt relief by all creditors, whether multilateral, bilateral or commercial. The Initiative was enhanced in 1999 as an outcome of a comprehensive review by the World Bank (International Development Association) and the IMF to provide more rapid relief to a wider group of countries.

Performance-based allocation system (PBAS)

An internal framework to identify and establish for each borrower a medium-term lending level (ex-ante allocation) to support IFAD's country development programme.

Programme Development Financing Facility (PDFF)

Budget for expenditures that represent combined costs relating to the development, supervision and implementation of projects.

Resources

The resources of IFAD are all the contributions received by it plus the funds derived or to be derived from operations or otherwise accruing to it in accordance with article 4.1 of the Agreement Establishing IFAD (IFAD financial regulation IV).

Executive summary

1. This paper sets out the financing requirements for the Eighth Replenishment of IFAD's resources, which include the estimated programme of work and how it and the related costs are to be financed from internal resources generated under the current framework (loan reflows, investment income and the use of future loan reflows through advance commitment authority) and external resources (Member State contributions).

2. The paper is divided into two main sections. Section I reviews, from a resource requirement perspective, three financial scenarios with different levels of programme of work and Member State contributions for the Eighth Replenishment period of 2010-2012. The first scenario, which will be used as the "base scenario", is the one proposed at the second session of the Consultation in April 2008 and consists of a programme of work of US$3.0 billion and Member State contributions of US$1.2 billion. Two additional scenarios will be compared against the base scenario: a "higher scenario" with a programme of work of US$3.3 billion and Member State contributions of US$1.5 billion; and a "lower scenario" with a programme of work of US$2.8 billion and Member State contributions of US$1.0 billion.

3. Section II discusses IFAD's financing structure and the major elements that currently define IFAD's resources, while shedding light on the estimated impact that debt relief under the Heavily Indebted Poor Countries Debt Initiative and the Debt Sustainability Framework will have on financial resources during the Eighth Replenishment period. In addition, it describes the varying levels of Member State contributions and advance commitment authority as a means of filling the financing needs.

IFAD's Eighth Replenishment – financial scenarios

I. Financial scenarios for IFAD's Eighth Replenishment (2010-2012)

A. Introduction

1. At the April session of the Consultation on the Eighth Replenishment of IFAD's Resources, IFAD made the case for a programme of work of US$3.0 billion between 2010 and 2012. On the basis of IFAD's past experience, a US$3.0 billion programme of work would catalyse a similar amount of cofinancing, resulting in an overall investment in support of rural poverty reduction of around US$6.0 billion over the three-year replenishment period.

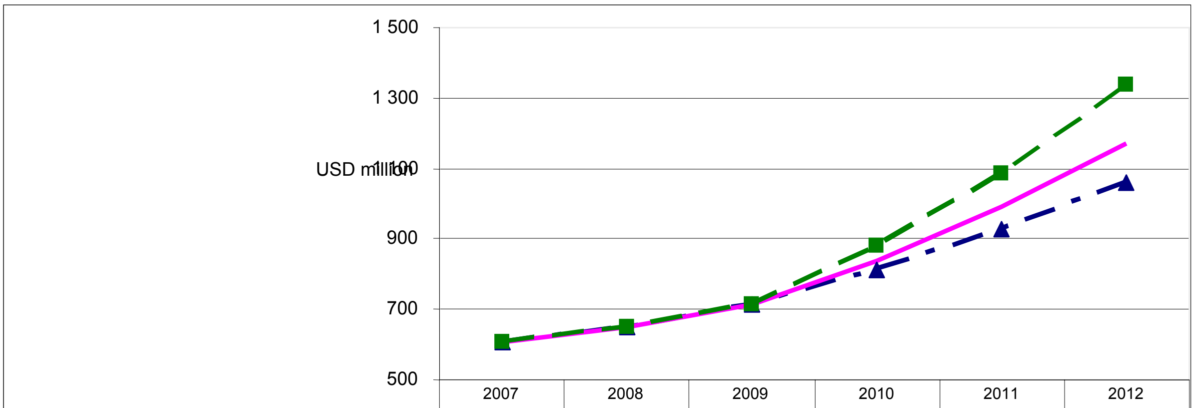
2. Reflecting the discussion on the demand for IFAD assistance during the Eighth Replenishment period, and in the light of the financial soundness of the institution, the required resources will come from Member State contributions, loan reflows, investment income and other internal funding, with the remaining shortfall met by the use of advance commitment authority (ACA).

3. Using the scenario presented at the April Consultation session as the base scenario, two additional scenarios (one with a higher and the other with a lower programme of work) have been presented at the request of the Consultation. All three scenarios are discussed in detail below.

B. Programme of Work for 2010-2012

4. The chart below shows the annual growth in IFAD's programme of work under the three alternative levels of US$2.8 billion, US$3.0 billion and US$3.3 billion.

Chart 1
Evolution of IFAD's programme of work in three proposed scenarios



	2007	2008	2009	2010	2011	2012
Lower scenario: Repl 1.0 bln, POW 2.8 bln	605	650	715	814	928	1 058
Base scenario: Repl 1.2 bln, POW 3.0 bln	605	650	715	839	991	1 170
Higher scenario: Repl 1.5 bln, POW 3.3 bln	605	650	715	880	1 084	1 336

(a) **Lower scenario:** the total programme of work would be US$2.8 billion, reaching about US$1.1 billion in 2012, the last year of the Eighth Replenishment period.

(b) **Base scenario:** the total programme of work would be US$3.0 billion, reaching about US$1.2 billion in 2012.

(c) **Higher scenario:** the total programme of work would be US$3.3 billion, reaching about US$1.3 billion in 2012.

C. Resource requirements

5. The breakdown of resource requirements and existing financing sources for the three levels of programme of work are summarized in table 1. The main assumptions are summarized in the annex.

Table 1
Resource requirements and financing sources for the Eighth Replenishment
(Millions of United States dollars equivalent)

	Lower scenario	*Base scenario*	*Higher scenario*
Resource requirements			
Programme of work (loans and grants)	2 800	3 000	3 300
HIPC Debt Initiative payments	157	157	157
Administrative budget and Programme Development Financing Facility (PDFF)	457	469	488
Total resource requirements	**3 414**	**3 626**	**3 945**
Internal sources of financing under existing arrangement			
Loan reflows	809	809	809
Others*	252	252	252
Investment income	197	202	211
Unused balance of 5 years ACA	475	482	492
Total internal financing sources	**1 733**	**1 745**	**1 764**
Eighth Replenishment financing gap	(1 681)	(1 881)	(2 181)

* Recommittable reflows from loan cancellations and reductions.

6. The internal financing sources would cover half of the total resources required for the lower and base scenarios and 45 per cent for the higher scenario. To finance the remaining balance, IFAD proposes an increase in Member State contributions together with a prudent extension of the current ACA ceiling of five years to seven years (see table 2).

Table 2
Scenarios for additional financing for the Eighth Replenishment
(Millions of United States dollars equivalent)

	Lower scenario	*Base scenario*	*Higher scenario*
Contributions from donors	1 000	1 200	1 500
Extension of ACA from 5 to 7 years	681	681	681
Total additional resources	**1 681**	**1881**	**2 181**

7. Following an overview of IFAD'S resource structure, section II will provide details on all these resource elements under the proposed financing scenarios.

II. IFAD's financial structure

A. Resource structure and definition

8. IFAD's financial structure is based on the definition of resources available for commitment set out in article 4 of the Agreement Establishing IFAD. Resources available for commitment are all those assets in freely convertible currency net of IFAD commitments for loans and grants.

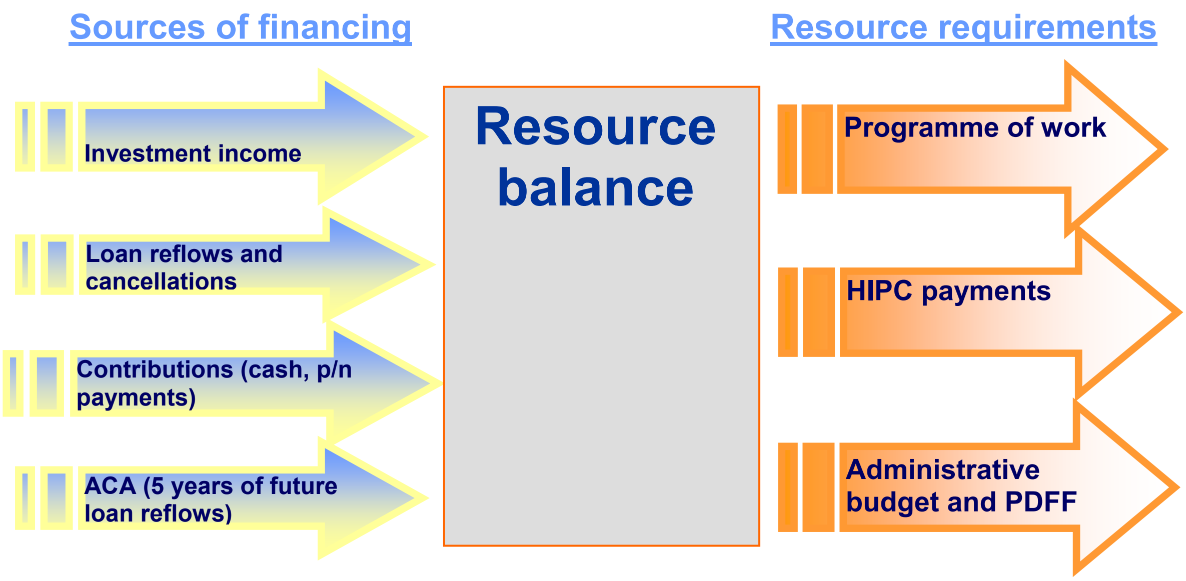
9. According to IFAD's resource definition, contributions are considered when paid in the form of cash or the deposit of a promissory note, whereas obligations are

considered at the commitment stage, which results in a prudent approach. IFAD's resources are thus defined by a full, prior financial backing of commitments.

10. In 1997, IFAD's Governing Council authorized the use of ACA to cover resource shortfalls in approving new loans and grants. The Executive Board approves the total resource commitment to be made through ACA at each of its sessions.

11. Chart 2 illustrates IFAD's financing sources and resource requirements as already shown in table 1. Each item will be discussed further below.

Chart 2
Dynamics of IFAD's resource requirements and financing sources



NOTE: p/n = promissory note

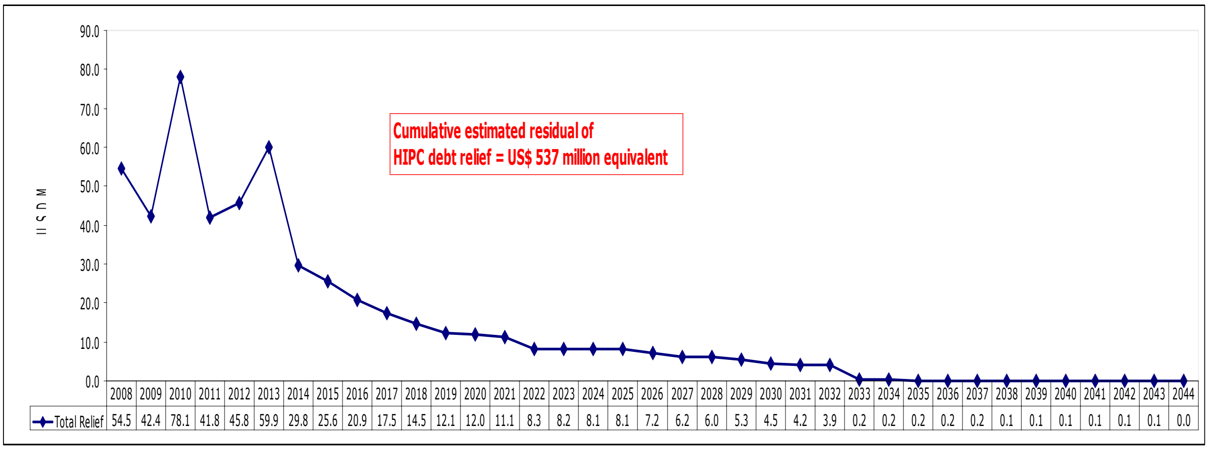
B. Resource requirements – impact of the Heavily Indebted Poor Countries (HIPC) Debt Initiative

12. **Programme of work.** The majority of IFAD's resource requirements are represented by loans and grants that are committed over each replenishment period (see table 1).

13. **Impact of HIPC payments.** IFAD is fully committed to the HIPC Debt Initiative. The total cost of IFAD participation in the overall Initiative is estimated at US$707.8 million in nominal terms.[1] As at 31 December 2007, IFAD had provided US$169.9 million in debt relief to 22 completion point countries. Funding for debt relief is provided through external contributions – from Member States and through the World Bank-administered HIPC Trust Fund – and from IFAD's own internal resources. The remaining US$537.9 million is spread over a period of 35 years as shown in chart 3. Based on the latest assumptions, the total HIPC payments for the Eighth Replenishment period are estimated at US$157 million in all three scenarios.[2]

[1] SDR/US$ exchange rate assumed at 1.5759 (as at 31 December 2007).
[2] The estimated HIPC payments for the Eighth Replenishment amount to US$166 million. The amount of US$157 million is net of the existing balance of previous internal and external contributions to the IFAD HIPC Trust Fund.

Chart 3
Estimated HIPC payment impact



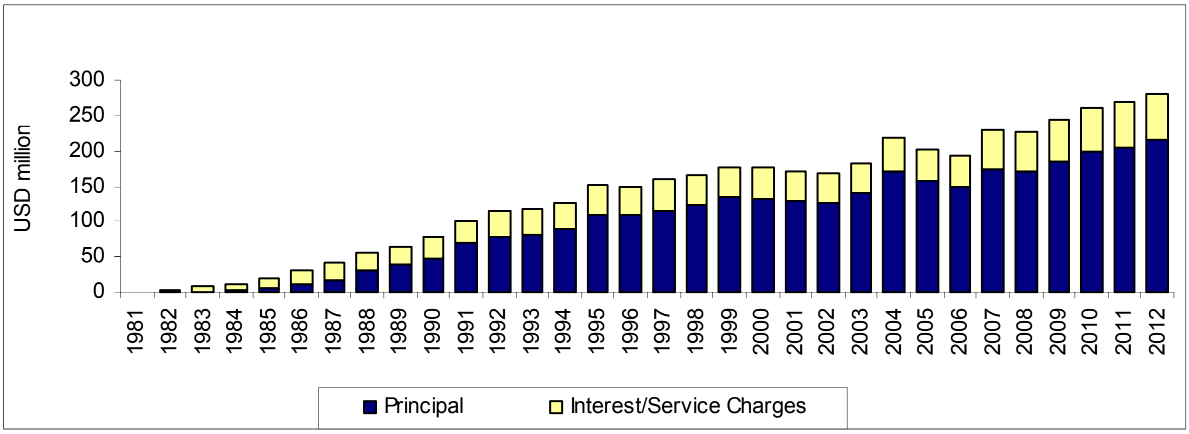
14. **Administrative budget and the Programme Development Financing Facility (PDFF).** Administrative budget and PDFF expenditures are all related to delivering the proposed level of the programme of work. In all three scenarios, PDFF growth is assumed to be in line with that of the programme of work while administrative costs are projected to increase at 2.0 per cent per year in real terms. Cumulatively, these two costs represent a total efficiency ratio[3] equivalent to 16.3 per cent for the lower scenario, 15.6 per cent for the base scenario and 14.8 per cent for the higher scenario. The total of administrative and PDFF budgets represents 13.4 per cent, 12.9 per cent and 12.4 per cent respectively of total resource requirements.

C. Existing financing sources for the Eighth Replenishment

Loan reflows – the impact of the Debt Sustainability Framework (DSF).

15. Loan reflows are derived from loan principal repayments, and interest and service charges. Over the past 29 years, loan reflows have increasingly become a stable internal resource (see chart 4). Currently, annual loan reflows are around US$200 million, and this level is expected to grow as IFAD's programme of work continues to expand in the coming years.

Chart 4
Evolution of annual loan reflows

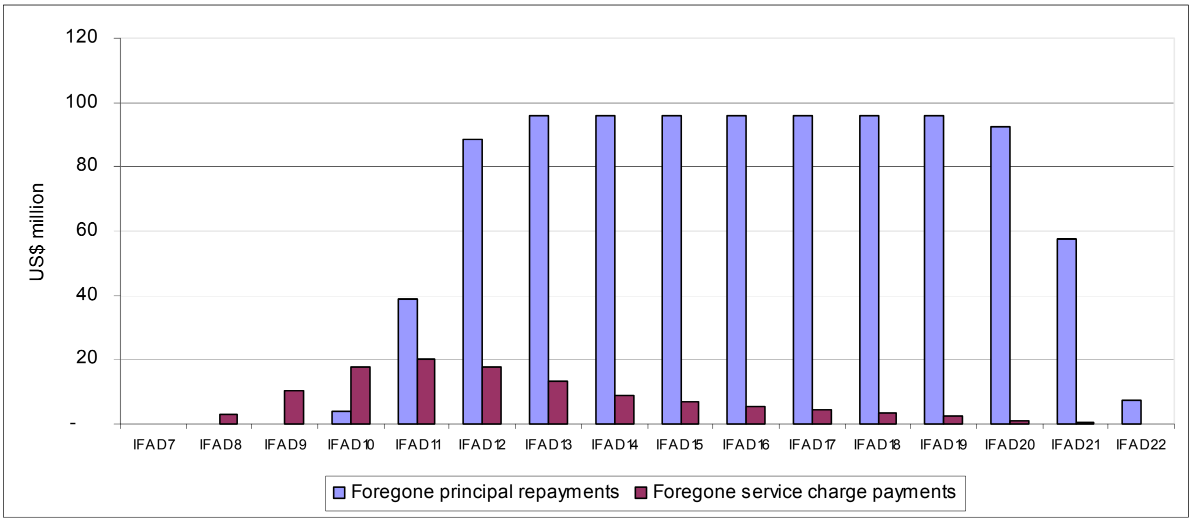


16. Since 1997, an average 3 per cent of loan reflows have been in arrears against the total outstanding loans. This represents an average loan recovery rate of 97 per cent, representing a very good loan service record of borrowing Member States.

[3] As reported in document EB 2007/92/R.2/Rev.1 on the programme of work, PDFF and administrative and capital budgets, IFAD has adopted as a benchmark an efficiency ratio defined as the total administrative and PDFF costs as a proportion of the programme of work level.

17. **Impact of DSF.** In April 2007, the Executive Board approved the implementation of the Debt Sustainability Framework, as recommended during the Seventh Replenishment consultations. The impact of the DSF during the Eighth Replenishment concerns service charges forgone, and the low amount involved – estimated at US$2.5 million – has already been netted against projected loan reflows. IFAD introduced the DSF to provide a certain portion of its highly concessionary loans in the form of grants. Member States agreed to compensate IFAD fully for the principal repayments forgone on a pay-as-you-go basis; they will not begin to do so until the end of the Tenth Replenishment period due to the high concessionality (10-year grace period) of IFAD loans. An overview of forgone reflows during each replenishment period deriving from Seventh and Eighth Replenishment commitments in the form of DSF grants is provided in chart 5 for illustrative purposes.

Chart 5
Forgone reflows of DSF grants
(approved in the Seventh and Eighth Replenishment periods)



Other reflows

18. Cancellations or reductions on original loan and grant amounts become available for new commitments.

Investment income

19. IFAD's general principle is that investments should be made with the exclusive purpose of providing and maintaining committable resources to be used by IFAD. The objectives are set out in the Agreement Establishing IFAD, that is, "to mobilize additional resources to be made available on concessional terms for agricultural development in developing Member States".

20. In investing its resources, the Fund is guided by the paramount consideration of security and liquidity. Within these constraints, IFAD seeks the highest possible return in a non-speculative manner (IFAD financial regulation VIII).

21. The investment portfolio, valued as at 31 December 2007 at approximately US$2.5 billion, is invested in high-quality fixed-income securities. All investment income is used as part of the internal financing sources to finance IFAD's programme of work and/or its operating costs. The investment portfolio is fully committed against approved loans.

22. Within these parameters, IFAD's prudent investment policy aims to achieve a 3.5 per cent annual net return. A look back at the performance history of the Sixth Replenishment (2004-2006) shows that the annual investment performance returns were at 4.54 per cent, 2.95 per cent and 2.46 per cent respectively. In 2007, the

investment return was 6.10 per cent, a very positive outcome for a 100 per cent fixed-income portfolio. But the investment performance is not guaranteed and is hard to project in a consistent manner given the very volatile markets at present and in the foreseeable future. Therefore, to provide some cushion against the uncertainties inherent in investment performance, investment returns are projected at 3.0 per cent per year in all three scenarios.

Advance Commitment Authority

23. As noted in paragraph 10, ACA was established in 1997. In all three scenarios, the maximum unused balance available under the current ACA (five-year future reflows) for the Eighth Replenishment is between US$475 million and US$492 million (see table 1).

D. Proposed financing for the Eighth Replenishment

24. Based on the above assumptions and projections, the financing needs presented in table 1 could be met in the following manner:

Member State contributions

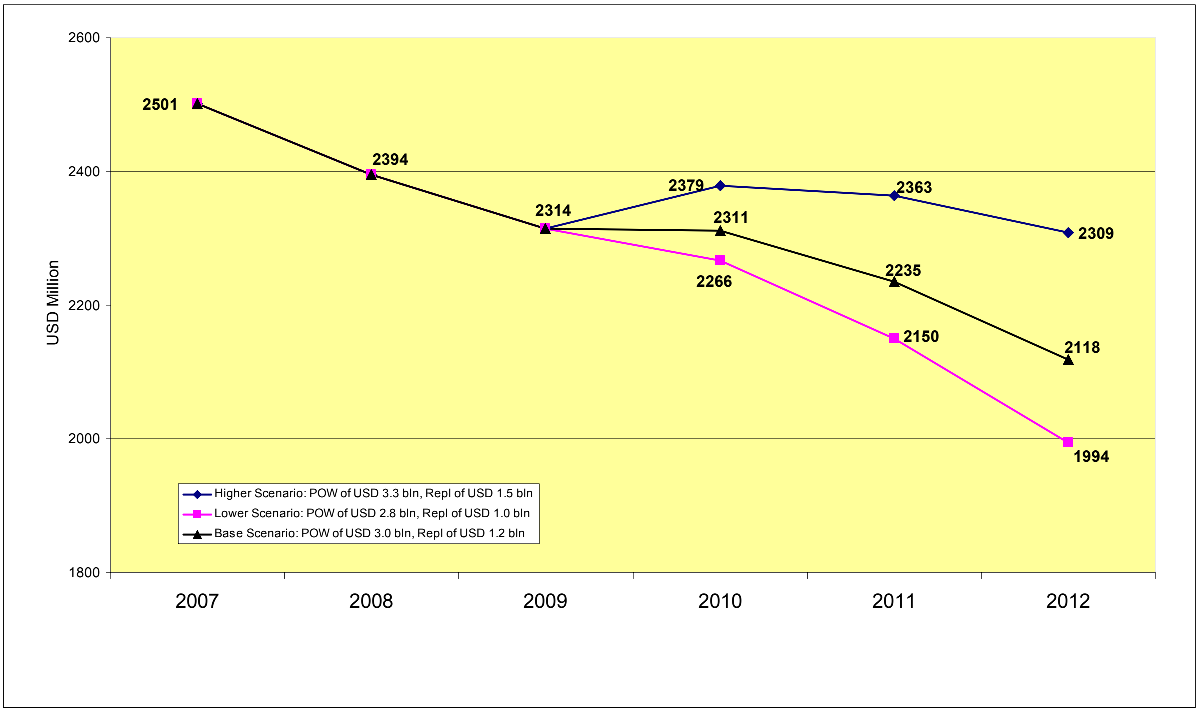
25. Member State contributions are presented in the three scenarios at a level of US$1.0 billion, US$1.2 billion and US$1.5 billion for a corresponding programme of work level of US$2.8 billion, US$3.0 billion and US$3.3 billion respectively. These proposed levels of financing by Member States would cover approximately one third of the total resource requirements, which corresponds to a proportion comparable to that of the Seventh Replenishment.

Extension of ACA

26. The remaining financing needs could be bridged by the extension of ACA from the current five years to seven years. This will enable a higher level of programme of work without compromising financial integrity to meet higher disbursement requirements.

27. In December 2006, a liquidity policy was approved by the Executive Board, requiring the investment portfolio to cover 60 per cent of the projected gross cash payments plus unexpected demand for cash each year until the end of the Seventh Replenishment. The liquidity policy framework is similarly applied in the context of the Eighth Replenishment. Chart 6 projects the investment portfolio balance over the Eighth Replenishment period for the three scenarios. During the Eighth Replenishment period, the investment portfolio is projected to remain in a US$2.0 billion to US$2.3 billion range.

Chart 6
Investment portfolio evolution



28. The cumulative amount of ACA used at end-2007 is US$585 million, and is projected to reach US$1.1 billion by the end of the Seventh Replenishment. By the end of the Eighth Replenishment, in all three scenarios the use of ACA is forecast at the level of 6.8 years (approximately US$2.3 billion). This is a prudent approach as further illustrated in a separate technical note on ACA.

III. Summary of financial scenarios

29. In summary, hereunder are the three financial scenarios:

(a) **Base scenario:** The total programme of work would be US$3.0 billion and Member State contributions US$1.2 billion. At the end of the Eighth Replenishment period, the investment portfolio is projected at US$2.1 billion and ACA use corresponds to 6.8 years.

(b) **Higher scenario:** The total programme of work would be US$3.3 billion and Member State contributions US$1.5 billion. At the end of the Eighth Replenishment period, the investment portfolio is projected at US$2.3 billion and ACA use corresponds to 6.8 years.

(c) **Lower scenario:** The total programme of work would be US$ 2.8 billion and Member State contributions US$1.0 billion. At the end of the Eighth Replenishment period, the investment portfolio is projected at US$2.0 billion and ACA use corresponds to 6.8 years.

Replenishment scenarios - assumptions

	Assumption
Debt Sustainability Framework:	As approved by the Executive Board at its ninetieth session
Administrative expenses:	Growth at 2 per cent per annum in real terms during the Eighth Replenishment
PDFF:	PDFF growth in line with the programme of work growth
Investment portfolio rate of return:	From 2008 onwards assumed at 3 per cent per annum
Loan service charges/interest rates:	As reported to the Executive Board in September 2007
HIPC debt relief costs:	HIPC debt relief provided on a pay-as-you-go basis according to amortization schedule
SDR/US$ exchange rate:	Assumed at 1.5759 (as at 31 December 2007)