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Investing in rural people

Borrowed Resource Access Mechanism: Framework for Eligibility and Access to Resources

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IFAD12 allocation and access mechanisms, and risk management considerations

I. Background

1. IFAD is seeking to expand its impact and instruments to meet the growing challenges posed by food insecurity, climate change and fragility. As noted in the IFAD12: Business Model and Financial Framework 2022-2024, IFAD is implementing a series of activities under a transformational financial framework reform. The aim is to allow the Fund to grow its programme of work while also ensuring financial sustainability and enhanced risk management. This will, however, depend on having new resources available to complement increased donor contributions. Whereas replenishment contributions will continue to be the bedrock of IFAD's financial architecture, the Fund will, in the Twelfth Replenishment of IFAD's Resources (IFAD12), further diversify its funding sources and access higher levels of borrowing to complement donors' contributions.
2. In this context, adjustments in the way IFAD allocates its resources are required to ensure that the ambition to reach greater impact is sustainable and aligned with available financial resources. The allocation system for IFAD12 will consist of two separate but interlinked mechanisms:
 - The **performance-based allocation system (PBAS)**, which will continue to be the mechanism for allocating IFAD12 core resources.¹ Its methodology will remain unchanged, with the exception of the changes, to be agreed in replenishment discussions, to the predetermined volume of grant resources for countries eligible for the Debt Sustainability Framework (DSF).
 - The new **Borrowed Resources Access Mechanism (BRAM)**, through which eligibility and access to borrowed² resources will be determined, based on development effectiveness, demand and creditworthiness.
3. This paper lays out the rationale behind the BRAM, discusses the principles and criteria for eligibility and selection, and identifies the potential synergies and interactions between the BRAM and PBAS mechanisms, as noted in the annex. The guiding principles will be agreed during the IFAD12 replenishment process. Additional details of the proposed mechanism will be presented in subsequent consultations (e.g. through informal seminars with Executive Board representatives). They will then be submitted to the Audit Committee for review and to the Executive Board and the Governing Council for approval in order to be effective for IFAD12.
4. This document does not address the pricing for these resources, which will be addressed in a separate document for the consideration of the appropriate governing bodies.

II. Rationale for developing a BRAM

5. The 2020 IFAD12: Strategic Directions paper proposed a financial road map to enhance the Fund's sustainability and maximize its development impact. Its goal is to increase IFAD's ability to offer customized development support to its diverse range of borrowers in order to enhance development impact while ensuring sustainable financing for Member States and the institution itself.
6. Recognizing borrowing as a key source of financing for IFAD's new operations, the ongoing financial architecture reform includes major milestones such as the completion of the credit rating process and the introduction of the Integrated

¹ Core resources are composed of replenishment funds, concessional loans (e.g. concessional partner loans) and concessional loan reflows.

² Borrowed resources are the funds that IFAD borrows from any source including bilateral loans, sovereign agencies, social impact investors, as well as reflows from loans sourced by such resources.

Borrowing Framework, which precede a funding plan to be approved by the Executive Board.

7. The funding plan will provide more transparency about the status of existing borrowing and present an update on borrowing needs, as well as their financial profile. Management has considered how these additional resources would be accessed by Members, taking into account: (i) the strategic priorities of the Fund; (ii) previous discussions³ of the PBAS Working Group, in which the need for a separate mechanism for borrowed resources was underlined; and (iii) the financial sustainability of both IFAD and potential borrowers.
8. The latter consideration obliges the Fund to ensure that access to borrowed resources: (i) at least preserves IFAD's cost of borrowing, through the overall pricing of onlending to IFAD's borrowers; (ii) preserves the non-subsidization principle between core and borrowed resources, and; (iii) does not create additional unsustainable debt for borrowers.
9. Recent replenishment documents such as the IFAD12: Business Model and Financial Framework 2022-2024, and IFAD's Comprehensive Approach to Graduation/Transition also provide details of IFAD's planned borrowed resources mechanism.

III. Principles for the BRAM

10. The BRAM, unlike the PBAS, will not have predetermined allocations for countries. Instead, it will include a series of principles which will help determine which countries, projects and programmes are eligible for receiving IFAD financing through the BRAM and how these will be prioritized. Individual selection of projects will be made after a rigorous internal review and presented to the Executive Board for approval. Three core principles form the basis of the proposed BRAM, as outlined below.
11. **Alignment with IFAD mandate and development effectiveness.** All resources intended for use in the BRAM must be aligned with: (i) IFAD's mandate and relevant Sustainable Development Goals; (ii) IFAD's objectives as currently set out in IFAD's Strategic Framework 2016-2025; and (iii) with the country strategic opportunities programme or country strategy note for the country in question. BRAM-financed projects should apply IFAD's targeting policies and incorporate mainstreaming themes. They should also reflect the national context of the beneficiary country, its institutional framework and relevant ongoing agricultural and rural development programmes. Finally, all projects must meet the same standards as those using core resources in terms of development effectiveness and potential to deliver impact. The framework for the BRAM will therefore be based first and foremost on ensuring that IFAD's mandate, policies and focus on development effectiveness are maintained.
12. **Demand from governments.** Demand will come from governments, who, working in coordination with IFAD country and project teams, will present project concept notes that are aligned with IFAD's mandate and meet its development priorities.

³ PBAS 2017/7, Meeting minutes (paragraph 15): "Management then addressed a key question: what would happen in the event that IFAD accessed market borrowing in IFAD12? Management reminded the Working Group that IFAD was the only international financial institution that used the PBAS to allocate both concessional and non-concessional resources (...) Should IFAD move forward with market borrowing, demand considerations would need to become explicit and better accounted for. Management clarified that two key parameters needed to be taken into account when allocating non-concessional resources: single borrower concentration and the borrower's credit rating. These parameters ensured that resources were provided in a financially sustainable manner. This could not be assured with the PBAS formula, hence the need for a separate resource allocation system for borrowed resources."

Projects must speak to IFAD's comparative advantage; projects that demonstrate strong government buy-in and ownership will be prioritized.⁴

13. **Financial safeguards.** The BRAM introduces a more flexible approach to lending practices so as to avoid a concentration of risks. This is required for this funding source considering IFAD's maturity as a financial institution and the risk management practices in place. Given that the funding of the BRAM will have borrowing costs as well as asset and liability management (ALM) requirements, access to borrowed resources must also take into account the borrower's creditworthiness and/or capacity to absorb additional debt.

IV. Criteria for eligibility and access

14. In addition to the foregoing principles, the following considerations will guide the selection and eligibility of projects through the BRAM.
15. **Eligibility.** Borrowed resources will be primarily accessed by upper-middle-income countries (UMICs) and selected lower-middle-income countries (LMICs) and low-income countries (LICs) (with or without PBAS allocations), if all relevant operational and financial criteria are met.⁵ To maintain an appropriate overall institutional focus, Management would aim to ensure that at least 80 per cent of IFAD's overall financing (PBAS + BRAM) is for LICs/LMICs, and that no more than 20 per cent goes to UMICs. Furthermore, in IFAD12, UMICs should be able to access at least the same share of total resources allocated to them as in IFAD11, i.e. 11 per cent of the programme of loans and grants (PoLG). Countries at high risk or in debt distress will not be eligible to access borrowed resources. Special attention will be given to countries in moderate debt distress after careful review of their exposure to shocks within the overall creditworthiness assessment and of their capacity to absorb additional semi-concessional debt. The review will take into consideration the debt sustainability analysis carried out by the International Monetary Fund (IMF), compliance with the IMF external debt limit policy, and IFAD's Non-Concessional Borrowing Policy.
16. **Additional borrowers.** LMIC or UMIC borrowers that have not received a PBAS allocation in IFAD11 but are interested in benefiting from IFAD's resources would be eligible, with the caveat that the total number of countries accessing IFAD PoLG funds (both core and borrowed) should be no more than 80. Countries that have borrowed from IFAD in recent cycles will be given priority to make the most efficient use of IFAD's administrative resources.⁶ The selection of new borrowers will take into account the costs of establishing/re-establishing operational links.

V. Benefits of new system: PBAS + BRAM

17. As IFAD's financial architecture matures to meet Member States' changing needs, and in line with the twin objectives of expanding and deepening the Fund's impact, the mechanisms used to determine access to resources must also mature. The PBAS, as revised and approved by the Executive Board in 2017, has done an excellent job of meeting IFAD's central objective of allocating resources to the poorest people in the poorest countries.
18. However, as a system based on maximizing allocations according to need and performance, the PBAS cannot always ensure a sustainable match between financing terms and allocation size. In order to ensure financially sustainable PBAS outcomes, DSF allocations for IFAD12 have been "ring-fenced" in order to

⁴ Government ownership could be demonstrated by: projects' ability to crowd in domestic resources or other cofinancing sources, or mobilize private sector financing; the performance of other projects in IFAD's portfolio, including on metrics of efficiency and sustainability; and use of products that have been demonstrated to increase ownership (e.g. results-based lending or multi-phased programmatic loans).

⁵ Eligibility does not guarantee access.

⁶ Countries borrowing between IFAD10 and IFAD11.

predetermine the overall DSF level that IFAD can provide under each replenishment scenario.

19. The combination of PBAS and BRAM will ensure IFAD can meet its objectives of diversifying its support in accordance with countries' changing needs and of expanding and deepening its impact. While PBAS will continue to ensure that IFAD's core resources benefit the poorest and the most vulnerable, while also maintaining existing priorities such as investments in sub-Saharan Africa and fragile states, the BRAM will allow countries of various income groups to access additional resources to realize transformative plans.
20. This will allow UMICs with high levels of inequality and enduring pockets of poverty to take advantage of IFAD's unique combination of generous financing and deep experience of rural development. But it will also provide LICs and LMICs with the capacity and ability to absorb additional funds to benefit from further IFAD resources. This second function allows for successful projects or programmes to be expanded, scaled or deepened, and for complementary investments to be realized.
21. More specifically, the combination of PBAS and BRAM resources will allow for larger investment projects, in line with the recommendations of the IFAD12 business model. Borrowed resources can also be used for project concepts that require scaling of PBAS lending programmes, and/or PBAS-funded projects designed with financing gaps. Phased approaches may also use borrowed resources if PBAS financing is not available. BRAM resources may also be used to fund regional lending programmes in which individual country PBAS resources have already been committed or are insufficient.
22. In addition, the overall financial sustainability of the Fund will be strengthened by the introduction of the BRAM due to the financial governance elements embedded in the mechanism. It can help diversify risk among regions and focus on projects with the best likelihood of success. It may also have positive implications on IFAD's cost of borrowing, and, subsequently, the final pricing that Member States sustain.

VI. Risks and mitigation measures

23. **Perception of mission drift.** Members may see a risk in making additional resources available on ordinary terms, namely that this could encourage countries to finance projects more loosely aligned with IFAD's core mandate of serving the poorest rural populations. The first of the principles listed above should strongly mitigate against this possibility: all projects presented for financing through BRAM resources must maintain a strong link to IFAD's mandate, targeting policies and mainstreaming themes, and speak to IFAD's comparative advantage. A recently completed demand study by the Overseas Development Institute suggests that there is demand for projects focused on rural transformation.
24. **Country limits and credit risk.** Country limits would be directly embedded in the Capital Adequacy Policy through the computation of the capital consumption of every country, derived from its credit ratings and periodically revised. Accordingly, indicative operational country limits (IOCLs) will be estimated as the prudent exposure to be maintained for each country in relation to its capital consumption. Another limiting factor will be a country's volume of borrowing from IFAD's overall resources during the cycle, similarly to the current limit applied to PBAS resources. Compliance with this threshold will be monitored for all countries, thus mitigating the risk of concentration.
25. **Leverage.** In line with its mandate, IFAD's capitalization has remained stable, showing no internal capacity to generate equity. With 86 per cent of assets financed by equity, IFAD's capitalization is, however, strong compared to other international financial institutions, notably multilateral development banks. Although borrowing resources will add pressure on IFAD's different risk metrics as a financial institution, Management has projected a conservative approach designed to keep leverage

around 40 per cent by 2030. This level of leverage has been assessed as adequate to protect IFAD's capital, although it will require monitoring depending on portfolio dynamics.

26. **Asset and liability management.** Added borrowing requires an adequate approach to ALM. With the operationalization of the ALM Framework, adopted in December 2019,⁷ Management will ensure monitoring of IFAD's debt maturity and repricing profiles and a more accurate calculation of the duration of assets and liabilities. This will ensure that mismatches are managed across the entire balance sheet to protect IFAD's capital.
27. **Insufficient borrowing.** While current IFAD12 scenarios expect IFAD to borrow a minimum of US\$900 million, IFAD has never borrowed this level of financing before and is still awaiting the conclusion of its credit rating process. There is therefore some risk that IFAD will be unable to leverage sufficient resources for the BRAM to be the right size. It is worth noting, however, that the implications of IFAD failing to borrow at the projected levels would have wider implications for the overall size of IFAD's PoLG. This would need to be scaled back should borrowing fail to materialize. Nonetheless, mitigation measures to ensure that UMICs receive at least 11 per cent of IFAD12 resources are also being discussed, including technical backstops to make certain that UMICs have access to these levels of borrowed resources while core resources are conserved for LICs and LMICs.
28. **Demand and supply of borrowed resources.** Adequate technical solutions will be designed to avoid a situation in which demand from LICs and LMICs does not reach the expected level of 80 per cent of total resources; or that IFAD's borrowing falls below levels ensuring sufficient access for UMICs. Management proposes a system similar to that used in the PBAS: reallocations between categories of countries could be considered later in the cycle to ensure supply meets demand.
29. **Debt management.** The availability of additional resources on less concessional terms could also present risks related to increasing debt burdens for LICs or LMICs currently not borrowing on those terms. This will be addressed by both the exclusion of countries on higher levels of debt distress from this funding source and the careful review of countries in moderate debt distress, as noted in paragraph 15.

VII. Legal considerations

30. **The Policies and Criteria for IFAD financing** state that the Fund's resources shall be allocated in accordance with a PBAS established by the Executive Board. The Executive Board shall report annually to the Governing Council on the implementation of the PBAS. The existing policies and criteria will have to be revised to reflect the BRAM, both in terms of recognition of the access mechanism and regular reporting to the Board.

VIII. Conclusions

31. IFAD is seeking to achieve greater impact while maintaining financial sustainability in a context of rapidly growing needs regarding food insecurity, climate change and fragility. Resource allocation and eligibility constitute strategic tools to achieve these ambitious goals while introducing further flexibility for adapting to the emerging needs of IFAD's clients, a core principle of the proposed IFAD12 business model.
32. Endorsement of the proposed approach will help IFAD strengthen its focus on the poorest of the poor and on the most vulnerable countries, while simultaneously making adequate resources available to countries with higher levels of per capita income and those intending to use additional IFAD resources in synergy with PBAS funding. It will have the added benefit of contributing to the financial sustainability of the Fund.

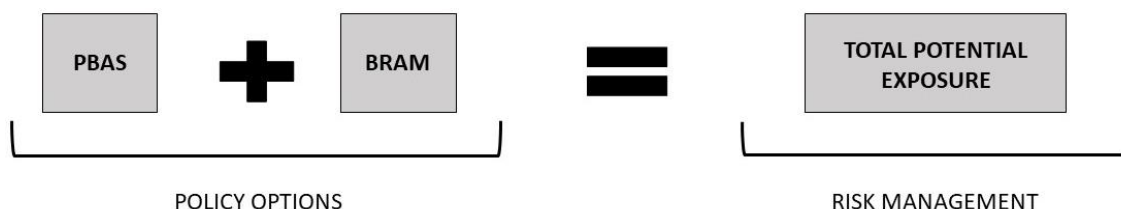
⁷ See document EB 2019/128/R.46

IFAD12 allocation and access mechanisms, and risk management considerations

1. Since 2003, IFAD's resources have been allocated through the PBAS, taking into account factors such as a country's individual need, its performance in relation to others and specific variables such as the targeting of rural populations, agricultural performance and the vulnerability index. The availability of resources constitutes the main input to the system. The need for additional sources of funding over and above core resources thus calls for the establishment of a new system of allocation matching the expected increase in borrowing.
2. Although the PBAS incorporates some indicators of country performance, it does not include a credit risk metric. Nor is it intended to serve as a tool for portfolio management, especially as regards the risk of concentration, an inherent problem affecting most of the multilateral development banks, notably those operating at regional level.
3. The BRAM is part of a package of comprehensive and sustainable support to borrowers on their development journey. It will be funded by borrowed resources and will complement PBAS-allocated resources, subject to demand and some eligibility criteria.
4. The optimization of resources will not affect risk management. In essence, the loan exposures (current and future) derived from the different policy options will be managed according to a risk management approach as per figure 1 below and described in the following paragraphs.

Figure 1

Allocation of resources versus risk management approach



5. **Risk management framework – country limits.** To support the change in IFAD's business model towards a hybrid structure capable of mobilizing resources other than contributions from donors, a Capital Adequacy Policy was approved in December 2019. The adoption of the policy represented a natural response to IFAD's more mature institutional profile as it gradually evolves and maximizes its development operations and impact through borrowing. The new policy serves to determine the available capital that can be leveraged and deployed for future operations. In sum, every risk stemming from IFAD's balance sheet (namely credit risk from loans) needs to be covered from a corresponding portion of its capital depending on the degree of risk.
6. The exposure management framework will be a key pillar of the Capital Adequacy Policy, facilitating the strategic oversight of IFAD's current and future financial position. The framework, a three-tier structure, sets prudential boundaries through targets and limits to optimize the Fund's capital utilization.
7. The prudential limits of the policy focus on the operationalization of lending activities in relation to risk arising from a single-country limit (SCL). This states that no country exposure in nominal terms should represent more than 20 per cent of the capital of IFAD8. It is the main limitation related to country risk management, and should not be breached in order to avoid jeopardizing IFAD's financial

⁸ The Basel Committee on Banking Supervision approach to concentration risk similarly recommends a limit of 25 per cent.

sustainability. It represents the most effective tool for ensuring the proper utilization of IFAD’s deployable capital, which must always remain above zero.

8. The SCL, however, does not consider credit risk. Credit risk considerations are directly embedded in the Capital Adequacy Policy through the computation of the capital consumption of each country, derived from the country’s credit rating, which is periodically revised. A country with a low rating will consume more capital compared to a country with a better rating. In order to consider this credit differentiation, IOCLs will be estimated as the prudent exposure to be maintained for each country in relation to its capital consumption. Compliance with this threshold will be monitored for all countries.
9. For every country, the IOCL serves two purposes. First, it acts as a reference for planning the distribution of resources through the BRAM for each replenishment based on the proposed selection criteria (including creditworthiness). Secondly, it serves as the main tool for capital planning over several replenishments. Stress scenarios to monitor the distance to the SCL will accompany it.
10. The SCLs and IOCLs will constitute the country risk framework to ensure lending decisions derived from the policy options are compatible with capital adequacy requirements and SCLs, as per figure 2 below.

Figure 2
Country risk framework

