

Document: TFWG 2018/2/W.P.3
Agenda: 4(a)
Date: 31 May 2018
Distribution: Public
Original: English

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Investing in rural people

Technical Note on the Phasing-out/Phasing-in Mechanism

Note to Transition Framework Working Group members

For ease of reference, new text added to the version presented at the first meeting of the Working Group is underlined.

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Working Group on the Transition Framework — Second Meeting
Rome, 28 June 2018

For: Review

Technical Note on the Phasing-out/Phasing-in Mechanism

Recommendation

1. The Working Group on the Transition Framework is invited to analyse and subsequently endorse the main elements of this document, as contained in paragraphs 1 to 4 and paragraph 26. The document will address:
 - The context of the implementation of the phasing-out/phasing-in mechanism, which is IFAD's proposal to address borrowers' transition between the different lending terms;
 - The objective of implementing the mechanism, which is to provide borrowers with greater predictability vis-à-vis financing terms by applying lending terms for a three-year cycle in principle, with eventual reversals to be effected normally on an annual basis, with very limited exceptions;
 - The reinforcement of discussions with countries at early stages of the replenishment cycle – through formulation of a robust and agile country strategic opportunities programme – on the financial and non-financial resources required to support project design, implementation and partnership;
 - The detailed implementation arrangements for this mechanism including: eligibility criteria; percentage of financing terms across the time period; and governing body authority and disclosure – also with reference to IFAD's "Increasing Transparency for Greater Accountability – Action Plan".
2. Upon endorsement, this will be reflected in the final Transition Framework document to be submitted to the Executive Board for approval in December 2018.

I. Background

1. The transition of the development status of countries is a lengthy process that can take even decades. IFAD reassesses lending terms on an annual basis, and has developed a transition methodology involving a phasing-out/phasing-in period over the replenishment cycle based on objective criteria for countries moving from more concessional terms to less concessional terms. This approach allows marginal changes in the base criterion (i.e. GNI per capita) to stabilize before financing terms are hardened. Under this approach, financing terms for each country will be revised formally once per replenishment cycle. Reversals from less to more concessional terms will continue to be applied on an annual basis unless immediate application is called for due to the specific circumstances of the case.
2. This mechanism was proposed in the Approach to a Transition Framework EB 2017/122/R.34, which was approved by the Executive Board in December 2017. The objective of this technical note is to:
 - (a) Provide a more detailed overview of the mechanism;
 - (b) Present a comparison with other international financial institutions' (IFIs) practices;
 - (c) Estimate related financial implications;
 - (d) Provide a legal viewpoint on the introduction of the new mechanism;
 - (e) Consider accounting and loan administration matters including billing and reporting;

- (f) Provide a summary of risk management considerations related to the mechanism including aspects related to transparency;
- (g) Provide a summary of the above points.

II. Overview of mechanism

3. Table 1 illustrates how phasing in less concessional terms over a three-year period would work.

Table 1
Example of phased approach to transition
 (Millions of United States dollars)

<i>Year of replenishment period</i>	<i>Financing terms</i>		<i>Numerical example: financing of US\$60 million</i>	
	<i>Highly concessional/ blend</i>	<i>Blend/ ordinary</i>	<i>Old financing terms</i>	<i>New financing terms</i>
Year 0 (prior to start)	Discussions with borrower			
Year 1	67%	33%	US\$40	US\$20
Year 2	50%	50%	US\$30	US\$30
Year 3	33%	67%	US\$20	US\$40

Box 1
Example of how phasing out/phasing in works

Scenario: As of 1 January 2019, a country's financing terms with IFAD change from highly concessional to blend terms due to a change in its GNI threshold.

IFAD engages in discussions with the borrower country regarding its lending programme for the next replenishment cycle 2019-2021.

If the country's lending programme (i.e. performance-based allocation system [PBAS] allocation) amounts to US\$60 million, IFAD will offer the following financing terms to the country:

- If the project is submitted for Executive Board approval during 2019, 67 per cent of the allocation will be granted on highly concessional terms and 33 per cent on blend terms;
- If the project is submitted for Executive Board approval during 2020, 50 per cent of the allocation will be granted on highly concessional terms and 50 per cent on blend terms;
- If the project is submitted for Executive Board approval during 2021, 33 per cent of the allocation will be granted on highly concessional terms and 67 per cent on blend terms.

Under current practice, the country would borrow the entire PBAS allocation on blend terms from 2019.

4. Some flexibility is envisaged in terms of the percentages indicated in box 1 at the request of the borrower, provided that the degree of concessionality of the overall package across the replenishment period is not negatively impacted. The Executive Board will have the authority to determine the eligibility of such cases on an individual basis.

III. Comparison with other IFIs

5. A benchmarking of IFAD's practices vis-à-vis the transition frameworks adopted by peer IFIs (the World Bank Group [WBG], African Development Bank [AfDB], Asian Development Bank [AsDB] and Inter-American Development Bank [IDB]) indicates that all peers have formal frameworks in place, including transition support. An analysis of the approaches adopted is provided in appendix 1.
6. The formal transition frameworks define roles, responsibilities and timelines for the transition of borrowers from one set of financing terms to another. Transition periods normally coincide with replenishment periods, so that changes are known in advance and planned. At the International Development Association (IDA) the transition process is triggered when national income exceeds the threshold for at least two consecutive fiscal years. In AsDB, the policies governing eligibility for

concessional terms are reviewed periodically during replenishment cycles. The process of transition normally takes about four years to complete after reaching the income threshold, mirroring the AsDB replenishment cycle. Debt distress classification is, however, reviewed annually. In AfDB, the length of the transition process is usually two to five years.

7. Several multilateral development banks draw up customized transition programmes for borrowers. When IDA determines that a country should graduate, a graduation programme is formulated, usually as part of the country assistance strategy, comprising a planned phasing out of concessional lending and a phasing in of non-concessional lending through the International Bank for Reconstruction and Development (IBRD). Similarly, in AfDB, a transition programme is drawn up for each country changing credit status. This enables borrowers to continue to access concessional resources on hardened financing terms (mix-financing) through a tailored transition programme that allows for a gradual phasing out/phasing in, before completely moving to non-concessional resources. These resources offer a larger volume of AfDB and other funding than previously available to the borrower and provide incentives for voluntary acceleration of graduation.
8. In AsDB, the policies governing concessional terms eligibility are reviewed periodically during replenishment rounds. The process of graduation normally takes about four years to complete, from when the country reached the income threshold. This period mirrors the AsDB replenishment cycle. Debt distress classification is, however, reviewed annually.

IV. Estimate of related financial implications

9. The financial implications of the proposed approach to transition can be assessed by the impact on overall liquidity, taking into consideration changes in the principal repayment period and loan income for IFAD following the introduction of the phasing in the new financing terms during the replenishment period.
10. A simulation was carried out based on the final scenario for IFAD resources approved under the Eleventh Replenishment of IFAD's Resources (IFAD11) Consultation. Taking as an example five countries that are expected to change to less concessional terms (from highly concessional to blend terms), together with their related potential (not confirmed) PBAS allocation for the IFAD11 period, various scenarios were run to assess the difference between current practice and the future use of a phasing-out/phasing-in mechanism. Details of the simulation are provided in appendix II.
11. As a conclusion, the impact on overall liquidity in any of the scenarios is negligible. This result was to be expected considering the small projected PBAS allocation for the five countries in transition compared to total PBAS allocations for the same replenishment period (i.e. US\$295.4 million versus US\$3,500 million).
12. Similar results are achieved when running the same scenarios but changing the lending terms from blend to ordinary, as shown in appendix II.

V. Legal viewpoint on the introduction of the new mechanism

13. From a legal standpoint, the new methodology is in line with the Policies and Criteria for IFAD Financing, which were revised to this end in February 2018.
14. If a financing agreement includes financing that is being provided on two different types of lending terms, two different loans will be specified and the agreement will stipulate the interest rate, maturity period, etc. applicable to each loan.
15. By project closure, all funds should have been drawn down proportionately from the two loan accounts and the repayments proportionately allocated to the balances of the two loans.

VI. Accounting and loan administration matters, including billing and reporting

16. Overall, the current systems and business processes that are in place to manage investment projects can accommodate the introduction of the phasing-in mechanism; however, adoption of the mechanism will mean that any financing to a borrower on specific terms must be recorded in both the Grant and Investment Projects System (GRIPS) and FlexCube as separate instruments per the underlying financial terms.
17. Schedule 2 of the financing agreement should clearly list the amounts by category for each financing instrument in order to ensure the timely and accurate inputs of loan administration details in FlexCube.
18. To ensure that proper disbursement controls are maintained by IFAD, the borrower should submit a separate Form 100 to support a withdrawal application for each financing instrument; however, the withdrawal application may also be submitted on a single form, provided that the application clearly lists the amounts by category for each financing instrument and that the same designated account banking instructions are used for each share of the financing. This approach is also consistent with the design of the newly implemented IFAD Client Portal.
19. Each financing instrument will have a separate amortization schedule and will generate a separate billing statement as the repayment schedule and interest charges will be unique to the approved lending terms of the loan.

VII. Summary of risk management considerations related to the mechanism

20. On risks relating to delivery, the phasing in of the new financing terms across the replenishment period provides an effective incentive for earlier use of PBAS allocations in the initial years of the replenishment.
21. It is also envisaged that with this mechanism some countries will continue to borrow from IFAD because, either by law or by preference, they cannot or will not use hardened terms for certain types of expenditures. It is important that IFAD communicates with the ministry of finance and the implementing agency at an early stage in the design of new projects in order to mitigate any potential repercussions.
22. On risks related to IFAD's sustainability, the impact on overall liquidity for each scenario is negligible.
23. On risks related to transparency, implementation of this mechanism will be accompanied by the disclosure of allocated lending terms to each borrower/recipient on IFAD's website and enhanced dialogue with borrower/recipient at an early stage, before the replenishment cycle begins and also during it. This enhanced transparency and public disclosure will assist in mitigating IFAD's reputational risks.
24. On legal and operational risk, it is expected that the mechanism will not result in a major change in legal documents and systems, and that current IFAD capacities will ensure smooth implementation of the mechanism.
25. On risks related to borrowers, the debt servicing unit will differentiate project expenditures by source of financing so as to reconcile each withdrawal application and the associated interest calculation accruing to each financial instrument.

VIII. Conclusion

26. The phasing-out/phasing-in mechanism will allow for a smooth and predictable transition to IFAD's less concessional financing terms and will have no significant

impact on IFAD's financial sustainability. Under this new mechanism, the financing terms for each country will be revised formally once per replenishment cycle. Reversals from less to more concessional terms will continue to be applied on an annual basis unless immediate application is called for due to the specific circumstances of the case. The overall risk related to the operational, legal, accounting and loan administration areas and to IFAD's reputational exposure and transparency is assessed as low.

Practices of IFAD and other IFIs

	IDA/IBRD	IFAD	AsDF/AsDB	AfDF/AfDB	IADB
Public disclosure	Country classification by eligibility to source of financing (IDA or/and IBRD), by income revenue category, by lending terms. Creditworthiness disclosed via a link to IMF website.	No	Country Performance rating- Yes Country Creditworthiness and credit ratings-not publicly available	Country Performance rating- Yes Country Creditworthiness and credit ratings-Yes	No
Frequency and timing of transition	Countries remain on blend terms for 2 replenishment cycles on average. Graduation process triggered when GNI threshold exceeded for at least 2 of 3 consecutive years.	Financing terms applied each year, 6 months after changes made by WB on July 1st	Review along with AsDF replenishment. Before replenishment period begins, ADB consults with donors on volume. Debt distress classification reviewed annually. Transition from AsDF to AsDB-normal process 4 years Full graduation beyond AsDB-normal process 5 years after crossing GNI thresholds.	Gradual phasing between AfDF and AfDB resources. For each country changing credit status, a transition programme is drawn up, defining modalities of support and AfDB role, length of transition and financing mix during that period. Normally 2-5 years after country has met both GNI and Creditworthiness criteria.	No specific period. Transition supported by a lending blending mechanism to ensure smooth reduction in concessionality rather than an abrupt change.
Frequency and timing of reversal	Yes-Annually	Yes- Annually	Yes-Annually	Yes- Annually plus consideration to access to specific financing related to fragility	Yes-to date no countries have "reverse-graduated"
Acceleration of graduation	Yes based on a discussion at country level	No	Yes based on a discussion at country level	Yes. Incentives for voluntary acceleration of graduation are offered	N/A

* Ordinary capital resources which considers AsDB concessional core resources

Estimate of related financial implications

- The starting point, or base scenario for this analysis has been based on the final scenario for IFAD resources approved in the IFAD11 Consultation, as shown below:

Millions of United States dollars		
Contributions	1 200	
Borrowing	430	
Borrowing/Contributions		36%
PoLG	3 500	
Grant	227	6.5%
DSF	586	16.7%
Highly Concessional	1 342	38.3%
Total Concessional	2 155	61.6%
Blend	543	15.5%
Ordinary	802	22.9%
Liquidity ratio*		62.5%

* Minimum liquidity requirement (or MLR) is 60 per cent of the total of annual gross disbursements (cash outflows) and potential additional requirements due to liquidity shocks.

- In order to quantify realistically the transition impact of a loan, an example was taken for the following countries, that are expected to change to less concessional terms (from highly concessional to blend terms), together with their related potential (not confirmed) PBAS for the IFAD11 period, as follows:

Country	Current Financing terms	IFAD 11 Financing Terms Y1	IFAD 11 Financing Terms Y2	IFAD 11 Financing Terms Y3	Planned PBAS IFAD 11 (US\$ million)
Cameroon	HC	33% blend-67% HC	50% blend-50% HC	67% blend-33% HC	43.8
Ghana	HC	33% blend-67% HC	50% blend-50% HC	67% blend-33% HC	36.9
Kenya	HC	33% blend-67% HC	50% blend-50% HC	67% blend-33% HC	52.4
Zambia	HC	33% blend-67% HC	50% blend-50% HC	67% blend-33% HC	34.7
Bangladesh	HC	33% blend-67% HC	50% blend-50% HC	67% blend-33% HC	127.7

- Four scenarios were run based on the information above:
 - Current practice: at year 1, 100% of the five countries' allocation is moved to blend terms at once (not reproduced for Y2 and Y3 for simplicity)
 - Proposed transition: at year 1, 33.3% of the five countries' allocation is moved to blend terms (66.7% stays at highly concessional terms)
 - Proposed transition: at year 2, 50% of the five countries' allocation is moved to blend terms (50% stays at highly concessional terms)
 - Proposed transition: at year 3, 66.7% of the five countries' allocation is moved to blend terms (33.3% stays at highly concessional terms)
- Simulation of the transition in each of the above scenarios was achieved by changing the PBAS percentages for the specific year (1, 2 or 3). Specifically, a portion of the total balances for the five countries approved at HC terms was re-allocated to blend terms (100% for scenario a., 33.3% for scenario b., 50% for scenario c., and 66.7% for scenario d.). Original PBAS percentages (i.e. from base case) were re-instated the following year.

5. The EOY liquidity for the years 2019-2066 for each scenario was then compared to the base case liquidity, to calculate the extent of any deviation as a proxy for the magnitude of impact.
6. The results that were obtained are shown in the two charts below:

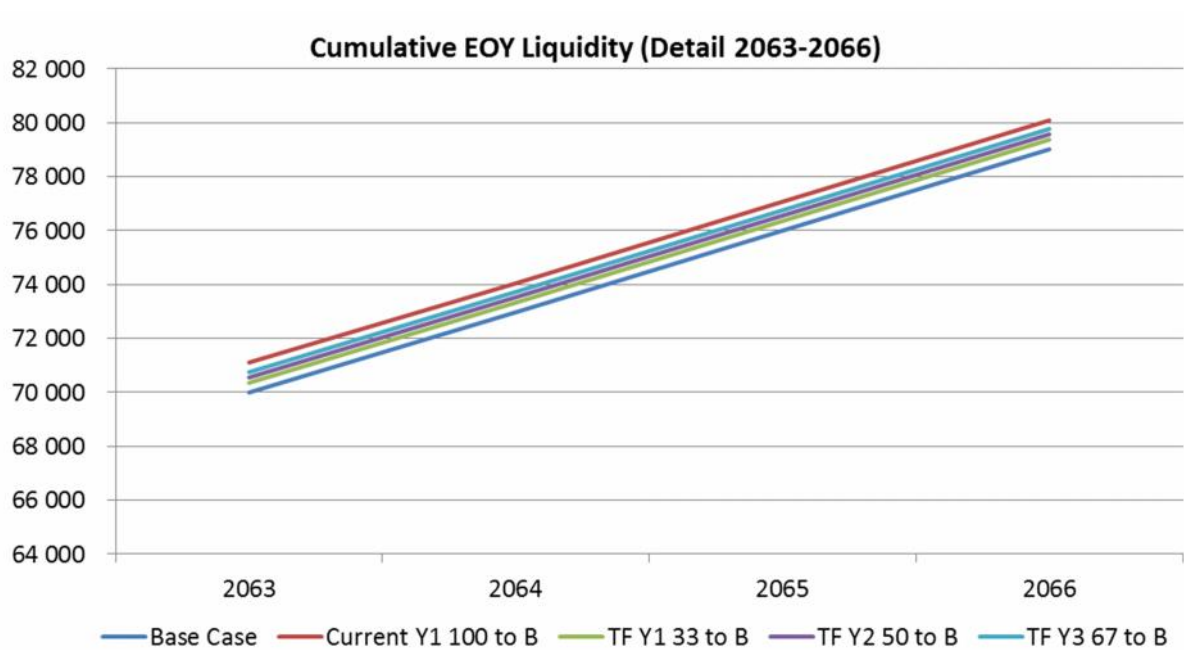
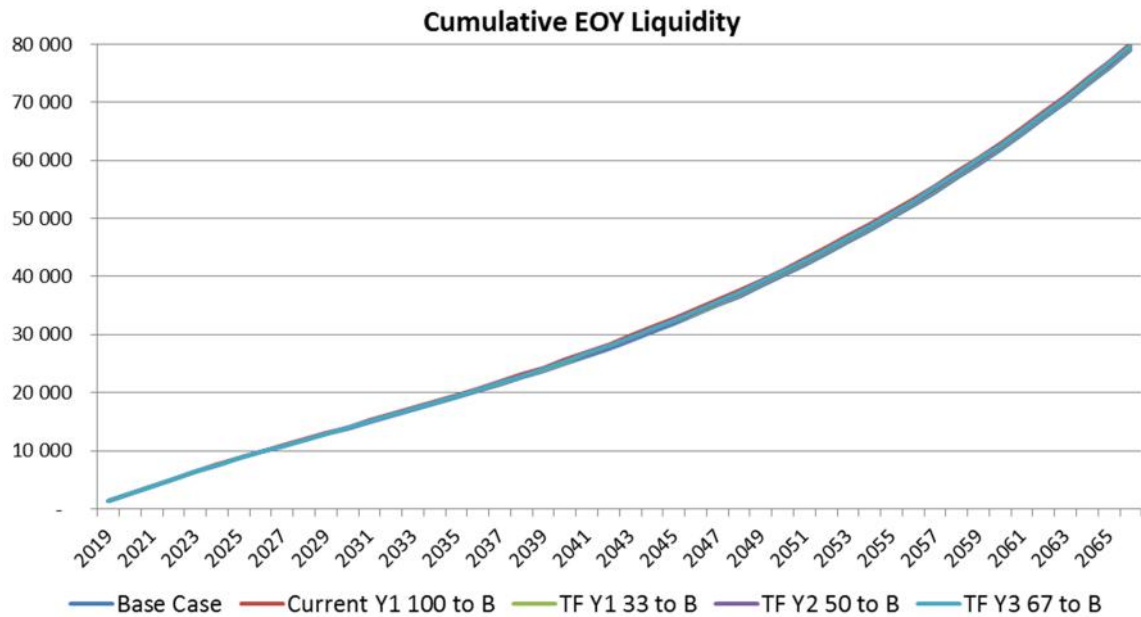


Table 2
Change in Net EOY Liquidity versus Base Case (US\$ million and %) - HC to Blend terms

Year	2063		2064		2065		2066	
	Amount (US\$ million)	%	Amount (US \$ million)	%	Amount (US \$ million)	%	Amount (US\$ million)	%
Base Case	69 994		72 965		75 978		79 007	
Current Y1 100 to B*	71 092	1.60%	74 063	1.50%	77 076	1.40%	80 106	1.40%
TF Y1 33 to B	70 356	0.50%	73 327	0.50%	76 340	0.50%	79 370	0.50%
TF Y2 50 to B	70 554	0.80%	73 525	0.80%	76 538	0.70%	79 567	0.70%
TF Y3 67 to B	70 759	1.10%	73 730	1.00%	76 743	1.00%	79 772	1.00%

* Current Y1 100 to B: current practice, at year 1, 100% of the five countries' allocation is moved from highly concessional to blend terms at once, TF Y1 33 to B: proposed transition: at year 1, 33.3% of the five countries' allocation is moved from highly concessional to blend terms, TF Y2 50 to B: proposed transition: at year 2, 50% of the five countries' allocation is moved from highly concessional to blend terms, TF Y3 67 to B: proposed transition: at year 3, 66.7% of the five countries' allocation is moved from highly concessional to blend terms.

7. As a conclusion, the impact on overall liquidity for any of the scenarios is negligible. This result was to be expected considering the small total projected PBAS allocation for the five countries that are in transition over the total allocation for the same replenishment period (i.e. US\$ 295.4 million/US\$ 3,500 million).
8. The results also clearly show that a smoother transition is achieved with the proposed phased approach, as all lines representing the Y1, Y2 and Y3 scenarios lie between the current practice scenario (top red line) and the base case (bottom blue line).
9. In fact, an immediate transition from highly concessional terms to blend terms as per current practice, is depicted by a sharp increase in liquidity (top red line), due to the direct application of less concessional terms for the borrowers, which generates increased cash inflows for IFAD. On the other hand, a smoother change of lending terms, as proposed in the transition approach, generates less cash inflows for IFAD in any of the years at the start of phasing in the less concessional terms.
10. Similar results are achieved when running the same scenarios but changing the lending terms from blend to ordinary.

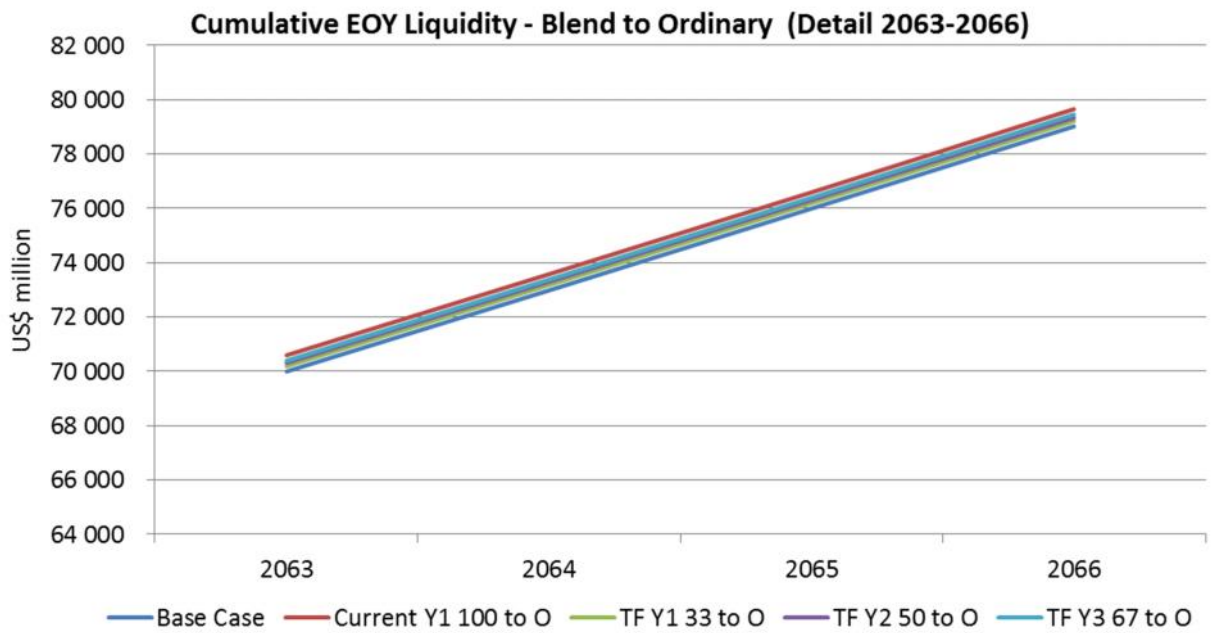
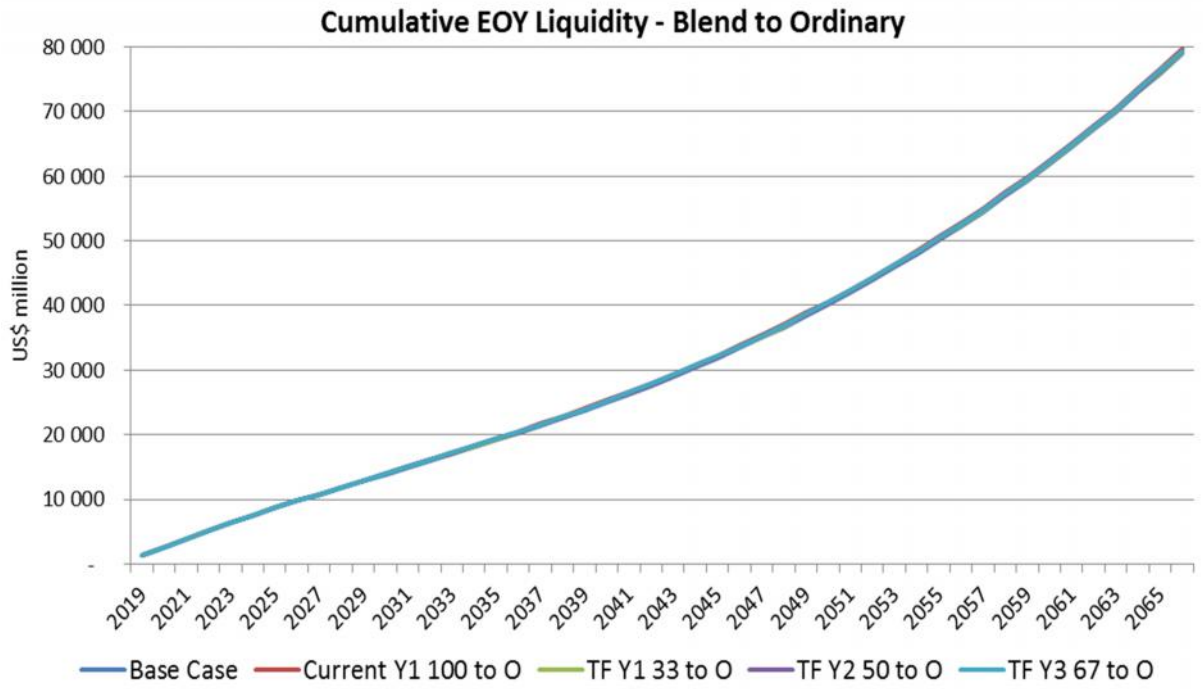


Table 3
Change in Net EOY Liquidity versus Base Case (US\$ million and %) - blend to ordinary terms

Year	2063		2064		2065		2066	
	Amount (US\$ million)	%	Amount (US\$ million)	%	Amount (US\$ million)	%	Amount (US\$ million)	%
Base Case	69 994		72 965		75 978		79 007	
Current Y1 100 to O*	70 595	0.90%	73 578	0.80%	76 603	0.80%	79 645	0.80%
TF Y1 33 to O	70 195	0.30%	73 170	0.30%	76 187	0.30%	79 221	0.30%
TF Y2 50 to O	70 301	0.40%	73 278	0.40%	76 297	0.40%	79 333	0.40%
TF Y3 67 to O	70 406	0.60%	73 385	0.60%	76 406	0.60%	79 444	0.60%

* Current Y1 100 to O: current practice, at year 1, 100% of the five countries' allocation is moved from blend to ordinary terms at once, TF Y1 33 to O: proposed transition: at year 1, 33.3% of the five countries' allocation is moved from blend to ordinary terms, TF Y2 50 to O: proposed transition: at year 2, 50% of the five countries' allocation is moved from blend to ordinary terms, TF Y3 67 to O: proposed transition: at year 3, 66.7% of the five countries' allocation is moved from blend to ordinary terms.