

profile

CORPORATE-LEVEL EVALUATION IFAD's financial architecture

Corporate-level evaluation on IFAD's financial architecture

IFAD's financial architecture is understood as the policies and systems adopted to mobilize, manage, allocate and disburse financial resources, in order to fulfil IFAD's mandate of helping to reduce rural poverty. This evaluation focused on the years from 2007 to 2017 due to the important changes in IFAD's financial architecture that took place in this period.

IFAD was established in 1974 as a Fund and Specialized United Nations Agency and is the only international financial institution focusing exclusively on agriculture and rural development. Periodic replenishments are at the heart of IFAD's financial architecture and its main source of financing. The structure of IFAD's balance sheet differs from that of multilateral development banks in that the latter have credit ratings and issue debt on the financial markets to leverage lending activities.

Sources of funding. IFAD's financial architecture has been centred on replenishment contributions and other non-reimbursable sources of funding (e.g. reflows from loans, income from treasury investments, supplementary funds, complementary contributions). Reliance on replenishments to finance its annual Programme of Loans and Grants served IFAD well during IFAD7 (2007-2009) and IFAD8

(2010-2012) replenishment periods, when the annual volumes of loans and grants consistently increased. However, since IFAD9 (2013-2015), the replenishments and reflows have been insufficient to finance the desired level of loans and grants. To fill this gap, IFAD began introducing modest amounts of debt through sovereign borrowing. For IFAD12 (period), Management is considering the option of borrowing on international capital markets. If this were to be the course of action taken, the challenge would be that of obtaining a high credit rating.

Allocating financing resources. The current system to allocate financing resources, based on the Performance-based Allocation System, has merits in terms of transparency. However, there are challenges regarding its future application, particularly if IFAD increases its sovereign borrowing or accesses capital markets. Only ordinary term loans would carry an interest rate margin capable of covering borrowing costs, but the performance-based system constrains IFAD's ability to increase ordinary lending relative to other types of lending.

Financial support instruments. Compared to other development finance institutions (DFIs), IFAD offers a limited range of financial products and flexibility of lending

terms. Other DFIs offer far more options for loan maturity and grace periods, amortization schedules and currency denomination. Considering IFAD's mandate and current strategic priorities, some financial products are missing, such as: (i) products to facilitate scaling up of development results; (ii) products to support integrated strategies for managing fragility and the risk of natural disasters; and (iii) a facility for pre-financing project implementation preparedness.

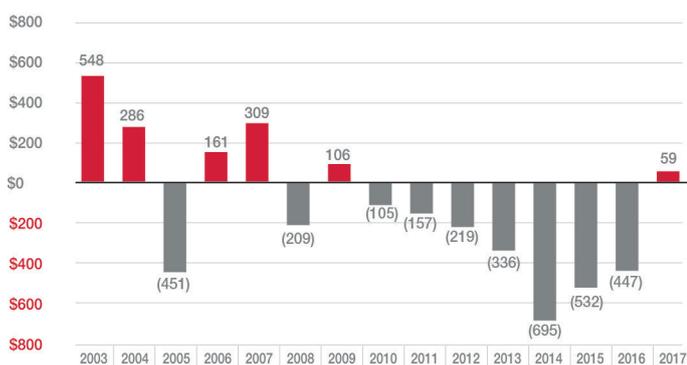
Financial oversight. The current internal and external systems of financial oversight are geared toward a low-risk environment, characterized by a relatively low level of borrowing. However, should IFAD shift to higher leveraging and sophistication of Treasury instruments, these systems may not be sufficient.

IFAD has made limited use of hedging instruments until recently and is exposed to risks of foreign exchange fluctuations. DFIs use derivatives for risk management purposes, manage interest rate risks on borrowings and loans, hedge future replenishment contributions, and provide options to borrow in some national currencies.

The current financial architecture is financially unsustainable. IFAD has incurred financial losses in the past decade (Figure 1), resulting in an erosion of its retained earnings and capital base. Revenues from interest on loans are too low to cover operating expenses. Moreover, operating expenses at IFAD in relation to total assets and to the annual volume of loans and grants are at the upper end of comparator DFIs, since IFAD does not benefit from economies of scale and operates in areas which are costly to serve.

Figure 1

IFAD's net income/loss 2003-2017 (millions of United States dollars)



Source: Elaboration from IFAD's financial statements.

The Debt Sustainability Framework (DSF) is part of the Fund's financial instruments but also a source of uncertainty for the Institution's financial sustainability. Compensation for the foregone principal will be made in the future, over four decades. While IFAD members have made and reaffirmed a commitment to repay the foregone principal, this agreement is not legally binding and vulnerable to future policy reversal. This would also pose threats to the assessment of IFAD's credit standing.

Four decades after its establishment, the financial architecture of IFAD requires important reforms. These reforms concern the mobilization of financial resources, the system for allocating financial resources, the leveraging of equity resources, the financial products available to respond to the need and demand of borrowing member countries, the financial sustainability of the Fund, as well as internal and external financial governance. Accomplishing these reforms will be essential in order to fulfil IFAD's unique mandate of rural poverty reduction and ensure its contribution to the Sustainable Development Goals.

Key recommendations

- Improve financial sustainability.** IFAD needs to address uncertainty regarding future compensation for the DSF. IFAD could adopt an up-front payment system: DSF would be moved to a special-purpose fund and not consolidated on IFAD's balance sheet. At each replenishment, new DSF funding would be approved only after the fund has been replenished. Second, IFAD needs to act on both its revenues and expenses in order to reduce the current structural deficit. On the revenue side, IFAD could increase the yield of the portfolio, notably by raising interest rate margins for ordinary loans. On the expense side, IFAD needs to devise strategies to contain its expenses while it increases its Programme of Loans and Grants, thereby improving its economies of scale.
- Enhance the flexibility of current financial products and consider new products.** IFAD should provide wider options regarding the loan grace and maturity periods, the choice of currency and the amortization schedule. IFAD could also learn from the practices of other DFIs in introducing new financial products in areas that correspond to its strategic priorities.
- Revise the financial allocation system.** If IFAD substantially increases its leverage through borrowing, it will need to onlend the proceeds for ordinary loans to avoid incurring losses. Therefore, IFAD would need to create a second lending window for ordinary loans, to be allocated through a risk-based system.
- Conduct preparatory work for potential access to capital markets.** IFAD needs to review the requirements to obtain a high credit rating. One of the likely requirements will be to reduce the uncertainty linked to future DSF compensation.
- Strengthen IFAD's financial governance.** If IFAD significantly increases its borrowing, it will be exposed to higher risks. The experience of other DFIs shows that this is manageable, but it will be important to enhance the capacity of the Governing Bodies for financial oversight. Moreover, internally IFAD will need to elaborate more detailed policies for asset and liability management and strengthen its risk management function.

For further information:

Independent Office of Evaluation of IFAD, Via Paolo di Dono, 00142 Rome, Italy
www.ifad.org/evaluation | e-mail: evaluation@ifad.org | [www.twitter.com/IFADeval](https://twitter.com/IFADeval) | www.youtube.com/IFADevaluation