



IDA13

**Further Options for
IDA13 Grant Financing**

**International Development Association
January 2004**

1. During the IDA13 Mid-Term Review discussions on November 4-5, 2003, Deputies considered several approaches for IDA13 grant financing based on a paper provided by IDA Management.¹ Deputies concluded that, pursuant to the IDA13 arrangements, “an equitable mechanism to address the impact of IDA13 grants on IDA’s financial framework needed to be put in place in advance of IDA14 negotiations.”² Deputies asked Management to refine options and provide updated proposals to Deputies by the first weeks of January 2004. This paper provides such options for consideration by Deputies.

2. Assuming that IDA will deliver 19.5% of the total envelope of development assistance as grants during the IDA13 period (FY03-05), IDA will forego about SDR 4.1 billion of nominal reflows over a 40-year period.³ Due to the long maturity structure of IDA credits, the net present value (NPV) of these foregone reflows is significantly lower, equivalent to approximately SDR 1.44 billion.⁴ Table 1 shows the breakdown of both values into losses on principal repayments, service charge and commitment charge.

Table 1. Estimated Cost of IDA13 Grants in Nominal and NPV Terms

Cost Item	Nominal Terms		NPV Terms 1/	
	(SDR million)	(in %)	(SDR million)	(in %)
Principal Repayments Lost	3,413	84%	1,064	74%
Service Charge Income (0.75%) Foregone	603	15%	324	23%
Commitment Charge Income (0.50%) Foregone	50	1%	47	3%
Total Cost of IDA13 Grants	4,065	100%	1,436	100%

1/ NPVs are valued as of FY06

New Options for Grant Financing

3. At the Mid-Term review, Management proposed three basic options for financing of the cost of IDA13 grants: upfront financing during IDA14 (Option 1); deferred financing commitments over 40 years (Option 2); and a combination of both approaches (Option 3). Among these options, the focus of the discussion was on Options 1 and 2. While the discussion ended without a conclusion, some Deputies expressed concern at the magnitude of incremental commitments in IDA14 under Option 1, particularly in view of existing budgetary constraints.

¹ *Compensating IDA for the Cost of IDA13 Grants*, IDA, October 2003.

² *Minutes of Meeting of IDA Deputies: IDA13 Mid-Term Review*, Washington DC, November 5, 2003, para 3.

³ IDA credits available to “IDA-only” countries carry a 40-year maturity schedule. It is assumed that IDA grants continue to carry no commitment charge, while IDA credits would carry a service charge of 0.75% p.a. and a commitment charge of 0.5% p.a. All cost estimates are based on the assumption that 19.5% of IDA13 assistance, the mid-point of the agreed policy range of 18-21%, would be extended as grants.

⁴ Based on a 5% discount rate per annum and valued as of the start of the IDA14 period in FY06.

4. To address these concerns, this paper describes two new options for grant financing which would achieve the same net present value of about SDR 1.44 billion as the original three options proposed during the Mid-Term Review. Both options are designed to reduce the amount of incremental donor contributions required during IDA14 when compared with Option 1, by extending the financing period over two to three IDA replenishments, i.e., over 6 to 9 years. At the same time, both new options largely meet the objective of ‘up-front’ financing. They have been designed to achieve financing of the cost of grants within 10 years from the start of IDA14, before most losses from foregone principal repayments on IDA13 grants would be incurred, given that IDA credits carry a 10-year grace period.

5. Table 2 illustrates Options 4 and 5. Under Option 4, donors would make aggregate contributions of SDR 610 million under each of IDA14, IDA15 and IDA16. Under Option 5, donor contributions would amount to SDR 850 million during each of IDA14 and IDA15. All contributions would be incremental to donors’ regular pledges.

Table 2. Options 4 and 5 for Grant Financing

		Option 4					Option 5		
		9-year schedule					6-year schedule		
		Donor Contributions	Donor Notes	Encashments			Donor Contributions	Donor Notes	Encashments
		SDR million					SDR million		
IDA14	FY06	610	203	203	IDA14	FY06	850	283	283
	FY07		203	203		FY07		283	283
	FY08		203	203		FY08		283	283
IDA15	FY09	610	203	203	IDA15	FY09	850	283	283
	FY10		203	203		FY10		283	283
	FY11		203	203		FY11		283	283
IDA16	FY12	610	203	203	IDA16	FY12			
	FY13		203	203		FY13			
	FY14		203	203		FY14			
Total		1,830	1,830	1,830	Total		1,700	1,700	1,700
NPV		1,445			NPV		1,438		

Note: NPVs do not exactly equal SDR 1.44 billion due to rounding of annual encashment figures.

6. Through these new options, donors would make binding financing commitments in the IDA14 arrangements for an aggregate contribution of SDR 610 million (under Option 4) or SDR 850 million (under Option 5). At IDA14, donors would also express their intention to provide future contributions of SDR 610 million each at IDA15 and IDA16 (under Option 4) or SDR 850 million at IDA15 (under Option 5). IDA would be taking some financial risk that individual donors might not be able to transform their political commitments into binding financial commitments at IDA15 (under Options 4 and 5) and IDA16 (under Option 4). This risk would be balanced by the benefit for Deputies and for IDA of achieving agreement on the mechanism of IDA13 grant financing.

7. Table 2 shows that encashments of the grant financing amounts in each IDA replenishment would take place within three years, in equal annual installments. As was the practice during previous IDA replenishments, individual countries would have the option to agree with IDA on alternative encashment schedules while maintaining the present value of their payments. Grant financing payments by donors would carry IDA voting rights.

8. The burden-sharing arrangements for IDA13 grant financing would follow IDA13 burden-sharing. Therefore, specific SDR volumes for IDA13 grant financing during IDA14-IDA16 would be known when a final option has been agreed upon by Deputies. Appendix 1 lists the SDR amounts to be contributed by each donor under Options 4 and 5.⁵ Donor commitments for IDA13 grant financing would be expressed in SDR terms. These SDR commitments would be converted into the same payment currencies, and at the same exchange rates, agreed for each IDA replenishment discussion (IDA14-16 for Option 4, and IDA14-15 for Option 5).

9. As in previous replenishments, the IDA13 arrangements included a “structural financing gap” of about 9% of total donor contributions.⁶ For IDA13 grant financing payments, the related structural financing gap totals SDR 171 million (under Option 4) or SDR 159 million (under Option 5). To fill this gap, Management would use the following two financing items available from the IDA13 replenishment round: (i) an amount of SDR 100 million which was set aside during IDA13 as a carry-over item from IDA12 to finance the long-term cost of IDA13 grants; and (ii) an amount of up to GBP 100 million (up to SDR 112.9 million) which the United Kingdom offered to provide contingent on agreement by Deputies on financing the provision of IDA13 grants. Management would expect to use the IDA12 carry-over item in full, and to cover the balance with about two thirds of the supplemental contribution by the United Kingdom. Details on the proposed use of these two financing line items are provided in Appendix 1.

10. It would be advantageous to reach consensus among all Deputies on one single option. Option 4 appears to provide the best balance between donors’ fiscal constraints and the broadly endorsed need to safeguard IDA’s finances. It also appears to command quite wide support.

11. Agreement on IDA13 grant financing will apply only to IDA13 grants. During the IDA14 discussions and subsequent IDA replenishments, Deputies may wish to consider whether to apply a similar mechanism or select other methods for grant financing in the future.

⁵ Independent of this system related to IDA13 grant financing, Deputies would discuss and agree on burden-sharing terms for their regular IDA14 contributions during the IDA14 discussions, just as has been the practice in previous IDA replenishment rounds.

⁶ The structural financing gap arises because the burden shares of all donors do not add up to 100%.

Use of IDA13 Grant Financing Resources

12. In order to ensure adequate financing of IDA for lost reflows due to IDA13 grants, the use of grant financing resources would need to follow two general principles: (i) achieving a rate of return on investment that is equal to the discount rate applied to calculate the net present value of reflow losses and the resulting grant financing payments by donors; and (ii) matching the investment horizon to the long-term cash flow profile from foregone reflows under IDA credits. A rate of investment lower than the discount rate would involve financial losses to IDA.

13. In calculating the cost of IDA13 grant financing, Management applied a 5% discount rate, representing the long-term return on IDA's liquid assets. This rate was selected initially on the assumption that grant financing resources could be invested as part of IDA's liquidity to replicate foregone cash flows due to IDA13 grants. During the IDA13 Mid-Term Review, Deputies supported the notion that other mechanisms be developed to deploy grant financing payments for development assistance purposes.

14. Management is exploring various alternative options for investing expected grant financing resources from donors. A first option relates to making available additional lending volumes at harder terms to IDA/IBRD blend countries below the operational income cut-off of \$865. Since grant financing resources would be additional to the existing IDA13 resource envelope under the performance-based allocation system for blend countries, IDA could offer these funds at harder than standard IDA credit terms to blend countries.

15. Funds would be allocated based on country demand. Demand would be a function of the interest rate to be charged in comparison with other financing alternatives available to these blend countries. The level of concessionality would be higher than for IBRD loans,⁷ but lower than under IDA's current terms applicable to blend countries.⁸ Funds could be targeted to specific economic sectors in blend countries, such as infrastructure and private sector development, that may be considered of high priority by Deputies. Given the rather low potential lending volumes involved of up to SDR 200 million per year, over 9 years, such harder-term lending by IDA to blend countries would not be expected to have a material impact on the demand for IBRD lending.

16. A second option would be for IDA to offer these resources to so-called 'gap' countries, at terms which would be harder than IDA's current 'hardened terms' for such countries.⁹ These resources would be additional to any existing country allocations under

⁷ For comparison purposes, as of mid-December 2003, IBRD's representative project loan terms carry an interest rate ranging between USD Libor plus 65 and 80 basis points. Converting this interest rate to a fixed-rate basis would provide an average, fixed interest rate of about 6.3% over 35 years.

⁸ IDA credits for blend countries have a 10-year grace period and a maturity of 35 years, with a standard service charge of 0.75% per year.

⁹ For 'gap' countries where the GNI per capita has been above the operational cut-off for more than two consecutive years, IDA credits at hardened terms involve a 10-year grace period and a maturity of 20 years, with a standard service charge of 0.75% per year.

IDA's performance-based allocation system. Gap countries are countries above the operational income cut-off for IDA but with inadequate credit worthiness for IBRD lending. These countries present a special challenge with respect to IDA's eligibility and graduation policies. Lack of access to IBRD resources for gap countries has led to demands for IDA funding. Using the additional IDA13 grant financing resources, at harder IDA terms than are applicable today, but at more concessional terms than are applicable for IBRD loans, could be a sensible proposition for these countries.

17. A third option would be for IDA to participate in development activities financed by the International Finance Corporation to support private sector investments in IDA countries. Various areas of potential cooperation are currently under investigation. First, IDA could join IFC in the syndication of loans to help borrowers meet their investment requirements. IFC's B-Loan program currently accounts for about USD 1.5 billion per annum. In principle, IDA funding could be mobilized in parallel to IFC's resources and those of other B-loan participants. IDA financing would be appropriate in those circumstances when commercial lenders display insufficient interest to support B-loans or parallel lending due to perceived risks or policy issues, including country exposure. In such instances, using IDA13 grant financing resources could generate private sector investments which otherwise would not materialize. Discussions to date indicate that risk-adjusted rates of return achievable for IDA would be comparable to the long-term return on IDA's liquid assets of 5% per annum.

18. Another area of potential cooperation with the IFC are public-private partnerships for infrastructure. Growing political uncertainty about privatization, risk-averse capital markets and the withdrawal of strategic investors from emerging markets have impeded the growth of private infrastructure in developing countries. In response, there has been growing interest in bringing together private sector investment with public sector resources. IFC has recently piloted a power project in Tajikistan where it combined IFC financing with IDA and bilateral grants. This arrangement had led to increased affordability of electricity for the poor and reduced political risks. There is widespread interest in replicating this type of model, especially in Africa. Preliminary analysis suggests that IDA13 grant financing resources could be used for such projects, provided the pricing of IDA's lending resources were sufficiently 'sub-commercial' and that IDA could change existing policy and lend without a sovereign guarantee.

19. All of the above options would require further research to assess their operational feasibility, to select an allocation mechanism for funds, to estimate associated potential lending volumes, and to determine achievable rates of return as well as expected investment horizons. In addition, Management would explore further options for lending at higher rates of return before the first donor payments for IDA13 grant financing would be encashed in FY06. Management would report back to Deputies with a final paper on investing the grant financing resources at harder-than-IDA credit terms. This paper would be made available by no later than the conclusion of the IDA14 replenishment discussions.

**Appendix 1: IDA13 Grant Financing - Donor Contributions under Options 4 and 5
based on IDA13 Basic Shares**

Contributing Members	IDA13 Basic Share (%)	Additional Contribution Per IDA Replenishment	
		Option 4 during IDA14, 15 and 16 (3 times SDR 610 million) SDR Million	Option 5 during IDA14 and 15 (2 times SDR 850 million) SDR Million
Argentina	0.05%	0.31	0.43
Australia	1.46%	8.91	12.41
Austria	0.78%	4.76	6.63
Belgium	1.55%	9.46	13.18
Brazil	0.61%	3.72	5.19
Canada	3.75%	22.88	31.88
Czech Rep.	0.05%	0.31	0.43
Denmark	1.58%	9.64	13.43
Finland	0.60%	3.66	5.10
France	6.00%	36.60	51.00
Germany	10.30%	62.83	87.55
Greece	0.12%	0.73	1.02
Hungary	0.06%	0.37	0.51
Iceland	0.04%	0.24	0.34
Ireland	0.18%	1.10	1.53
Israel	0.10%	0.61	0.85
Italy	3.80%	23.18	32.30
Japan	16.00%	97.60	136.00
Korea	0.91%	5.55	7.74
Kuwait	0.14%	0.85	1.19
Luxembourg	0.10%	0.61	0.85
Mexico	0.05%	0.31	0.43
Netherlands	2.60%	15.86	22.10
New Zealand	0.12%	0.73	1.02
Norway	1.52%	9.27	12.92
Poland	0.03%	0.18	0.26
Portugal	0.20%	1.22	1.70
Russia	0.08%	0.49	0.68
Saudi Arabia	0.39%	2.38	3.32
Singapore	0.14%	0.85	1.19
Slovak Republic	0.01%	0.08	0.11
South Africa	0.08%	0.49	0.68
Spain	1.80%	10.98	15.30
Sweden	2.62%	15.98	22.27
Switzerland	2.43%	14.82	20.66
Turkey	0.09%	0.55	0.77
United Kingdom	10.14%	61.85	86.19
United States	20.12%	122.73	171.02
Venezuela	0.03%	0.18	0.26
Sub-total	90.63%	552.86	770.38
<i>Structural financing gap</i>	<i>9.37%</i>	<i>57.14</i>	<i>79.62</i>
Total additional contributions	100.00%	610.00	850.00
<i>Proposed coverage of structural financing gap</i>			
(i) IDA12 carry-over item (SDR 100 Million total)		33.33	50.00
(ii) UK supplemental funds (up to SDR 112.9 Million total)		23.81	29.62
Structural financing gap per replenishment		57.14	79.62
Cummulative structural financing gap for each Option		171.41	159.24