



IDA13

**Compensating IDA for the Cost
of IDA13 Grants**

**International Development Association
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Executive Summary

1. During the IDA13 period (FY03-05), assuming that IDA will deliver 19.5% of the total envelope¹ of development assistance in grant form, IDA will forego a net present value (NPV, valued as of FY06) of approximately SDR 1.4 billion of reflows from principal repayments, service charge and commitment charge. To compensate IDA for the NPV cost of IDA13 grants, Deputies could choose among the following three options:

- Option 1: Upfront Commitment at IDA14. Donor governments could make an incremental, upfront commitment during the IDA14 replenishment discussions in order to compensate IDA for the cost of IDA13 grants. Donors could choose to make related payments either upfront (SDR 1.44 billion, paid at the start of the IDA14 replenishment cycle, in FY06); in line with IDA14 encashments (SDR 1.8 billion, paid over 9 years); or using alternative payment schedules.
- Option 2: Deferred Commitments. Donors could make successive commitments over 40 years in order to compensate IDA for the cost of IDA13 grants, reflecting the timeline of foregone reflows under the grants. Under Option 2.a., donors could choose a pay-as-you-go approach by back-loading commitments to outer years, rising to about SDR 450 million by IDA21. Under Option 2.b., donors could select an annuity approach by committing about SDR 230 million per IDA replenishment from IDA13 to IDA26.
- Option 3: Combining Upfront and Deferred Commitments. Donors could commit SDR 600 million at IDA14, of which SDR 410 million would constitute an upfront reimbursement of the NPV cost of foregone service charge and commitment charge income. The balance of SDR 190 million would be the first of a series of annuity commitments of SDR 190 million, for each replenishment from IDA14 to IDA26, to compensate IDA for the cost of lost principal repayments under IDA13 grants.

2. Option 1 would give rise in principle to issues related to use of the compensatory resources, for example, as between investments to replace reflows, possible front-loading of IDA assistance to support the Millennium Development Goals, and/or lending to “intermediate” borrowers on harder terms. By contrast, Option 2 would result in a bill to donors that would increase over time. It would carry the risk that the bulk of payments fall due in a relatively distant period for which donors cannot make credible commitments. This applies to a lesser degree if donors adopted an annuity rather than pay-as-you approach, as further set out below. Option 3 intends to avoid a situation where current IDA borrowers paying service and commitment charges effectively subsidize IDA grant recipients, since grants carry no such charges; because the administrative cost of IDA13 grants is incurred in early years, these costs could be compensated early on. Option 3 would still result in substantial donor payments for principal compensation in distant years.

¹ The value of 19.5% is the mid-point of the agreed policy range of 18-21% for grants under IDA13.

3. When considering these options, Deputies may want to consider the implications for future IDA replenishments if IDA continues to offer grants beyond the IDA13 period, assuming that the mechanism selected for IDA13 grants was to be applied in future IDA periods as well. Under Options 2 and 3, where future commitments would extend beyond the IDA14 replenishment cycle, cashflow costs for donors in outer years would rise sharply. These future costs would arise in addition to existing funding issues relating to the HIPC initiative. Donors already have to manage the additional HIPC costs to IDA well into the next decade.

Introduction

4. During the IDA13 replenishment period (FY03-05), 18-21% of IDA's development assistance is expected to be delivered in the form of grants. Grants require no repayment from recipients and therefore reduce future reflows available to IDA and its borrowers. IDA Deputies agreed to discuss the grant compensation issue at the IDA13 Mid-Term Review and "decide at that time on an equitable mechanism to provide for grant financing requirements".² The purpose of this paper is to offer a menu of possible mechanisms to achieve this objective.

5. As part of the IDA13 replenishment, an amount of SDR 100 million has been set aside as a carry-over item from IDA12 in order to finance the long-term cost of grants during IDA13. In addition, the United Kingdom indicated its willingness to provide up to GBP 100 million (SDR 112.9 million) contingent on agreement on financing the provision of grants.

Cost of IDA13 Grants

6. IDA's funding and commitment authority framework relies on donor contributions, IBRD net income transfers and internal resources. Currently, internal resources, primarily reflows from past lending, account for roughly 40% of IDA's total commitment authority. For example, over the next five years, IDA expects to receive \$2-3 billion of reflows from principal payments per annum. This level of resources is crucial for IDA to be able to maintain its projected volumes of development assistance. Even if IDA borrowers will achieve high rates of economic growth in years and decades to come, there will be a need for continued, large volumes of concessional financial assistance well into the future. Without adequate reflows, IDA's capacity to deliver this development assistance will be severely hampered.

7. Approximately one fifth of IDA13 assistance will be delivered in grant form. IDA will not receive any principal repayment from grants, and currently there is no mechanism

² *Additions to IDA Resources: Thirteenth Replenishment Supporting Poverty Reduction Strategies*, IDA R2002-0136, July 12, 2002, paragraph 89.

in place to recover the administrative expenses associated with grants. Under the IDA13 arrangements, “Deputies stressed that the impact of grants on IDA’s finances should be explicitly treated in IDA’s financial framework and that the costs should be specifically compensated for by additional donor contributions in order to maintain IDA’s financial integrity into the future.”³

8. Assuming that IDA will deliver 19.5% of the total envelope of development assistance in grant form, during the IDA13 period (FY03-05), IDA will forego about **SDR 4.1 billion** of nominal reflows over a 40-year period.⁴ 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 1.4 billion**.⁵ 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

9. In order to compensate IDA for the cost of IDA13 grants, Deputies could consider several options to protect IDA from the loss of associated reflows of principal and charge income. All of the following options are designed to achieve compensation for an NPV value of SDR 1.4 billion, calculated as of the beginning of FY06. Deputies reviewed some of these options during the IDA13 replenishment discussions.⁶ This paper presents a range of options in order to provide a menu of alternatives for consideration by Deputies.

³ Id.

⁴ 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.

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

⁶ During the IDA13 replenishment discussions, two scenarios were presented whereby donors would make additional contributions over 20 years, either beginning immediately from IDA13 or starting after 10 years from IDA16 onwards. There was also a discussion on an annuity scheme and a pay-as-you go mechanism.

Option 1: Upfront Commitment at IDA14

10. As a first option, Deputies could decide to commit upfront to provide the required resources to IDA, while allowing various degrees of flexibility in terms of the actual payment schedule for these resources. One advantage for donors would be to reach agreement on the subject without a need to reconsider this topic at a future point in time. An upfront commitment would also avoid a scenario of sharply rising incremental commitments by donors over time, should grants be included as part of future IDA replenishments, beyond IDA13.

11. In order to stay within the existing budget and parliamentary processes for IDA replenishments, it is assumed that donors would make their grant funding commitments **in addition to – but as part of – their IDA14 replenishment contributions**. Payments under Option 1 could be timed in different ways.

- a. Donors could deliver their up-front commitment during IDA14 through a **lump-sum cash payment at the start of the IDA14 replenishment cycle** (at the beginning of FY06). Under this scenario, donors would make an incremental funding commitment of about **SDR 1.44 billion** to IDA during IDA14.
- b. Alternatively, donors could decide to top-up their IDA14 contributions by about **SDR 1.8 billion**, and IDA would encash these additional contributions under the agreed encashment schedule for IDA14. For example, payments with a **9-year encashment schedule** are shown in Table 2.⁷ The NPV of total encashments would represent the required NPV to compensate for the cost of IDA13 grants.

**Table 2. Encashment Schedule for Additional Donor Contributions under IDA14
Using a 9-year Encashment Profile**

Year	1	2	3	4	5	6	7	8	9	Total
Fiscal Year	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	
Encashment share (%)	3%	10%	16%	18%	16%	13%	10%	8%	6%	100%
Encashment amounts (SDR million)	54	180	288	324	288	234	180	144	108	1,800

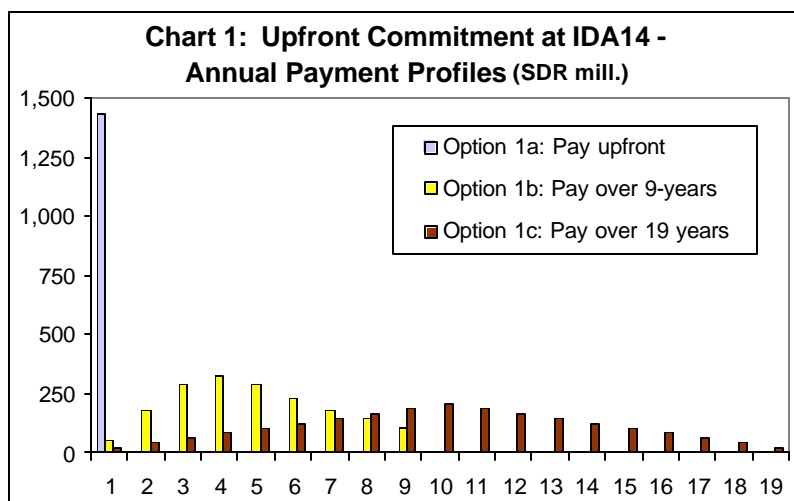
- c. Another variant of Option 1 would be to provide a more extended period for donor contributions. One example would be for donors to give promissory notes to IDA for each of 10 years, and then IDA would encash these IOCs over an additional 10 years. Under this example, at the time of the IDA14 replenishment discussions, donors would commit an amount of **SDR 2.3 billion**, in addition to their regular IDA14 contributions. Through this scheme, donors would extend the **encashment period up to 19 years**, as shown in Table 3.

⁷ A 9-year encashment schedule has been used under previous IDA replenishments.

Table 3. Encashment Schedule for Additional Donor Contributions under IDA14 Using an Extended, 19-year Encashment Profile

Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	Total
Fiscal Year	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24	
Encashment share (%)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	9%	8%	7%	6%	5%	4%	3%	2%	1%	100%
Encashment amounts (SDR million)	23	46	69	92	115	138	161	184	207	230	207	184	161	138	115	92	69	46	23	2,300

12. The following Chart 1 illustrates the payment profiles under each of these three scenarios in Option 1, over up to 20 years.



Option 2: Deferred Commitments

13. Rather than committing resources upfront during the IDA14 replenishment discussions, Deputies could opt to make deferred commitments over an extended period of time in order to compensate IDA for the cost of IDA13 grants. For the purposes of this paper, it is assumed that Deputies would elect to spread out their commitments over a period of 40 years (IDA13 to IDA26), in order to reflect the timeline of foregone reflows due to IDA13 grants.⁸

14. There are two possible scenarios for the timing of commitments and payments under Option 2.

- a. Donors could opt for a **‘pay-as you-go’ approach (PAYG)**. The nominal amount of foregone reflows amounts to SDR 4.1 billion over the 40-year period. Cashflow losses in earlier years, however, are modest, because IDA credits carry highly concessional terms, with a 10-year grace period and back-loaded amortization schedules.

⁸ The existing IDA13 commitments for compensating IDA for the cost of grants equal up to SDR 212.9 million, as set out at the beginning of this paper.

If Deputies decided to compensate IDA only when cashflow losses actually occur - and make the associated funding commitments during future IDA replenishment cycles - additional contributions required from donors during the IDA13-IDA15 period would be minimal. The majority of commitments would occur in outer years, **rising to about SDR 450 million by IDA21** (equivalent to payments of SDR 150 million per annum by FY27). Table 4 shows required incremental donor commitments per replenishment period and associated annual payments under a PAYG mechanism. It is assumed that donor commitments will be encashed in three equal annual installments during each IDA period.

Table 4. PAYG Approach: Donor Commitments and Payments to Offset Loss of Reflows due to IDA13 Grants
(SDR million)

IDA Replenishment Period	IDA13	IDA14	IDA15	IDA16	IDA17	IDA18	IDA19	IDA20	IDA21	IDA22	IDA23	IDA24	IDA25	IDA26	Total
Commitment per IDA Period	38	67	75	144	277	272	290	442	456	446	437	428	419	274	4066
Fiscal Years	FY03-05	FY06-08	FY09-11	FY12-14	FY15-17	FY18-20	FY21-23	FY24-26	FY27-29	FY30-32	FY33-35	FY36-38	FY39-41	FY42-44	
Payments per Year ^{1/}	13	22	25	48	92	91	97	147	152	149	146	143	140	91	

1/ Assuming full encashment during each three-year replenishment period.

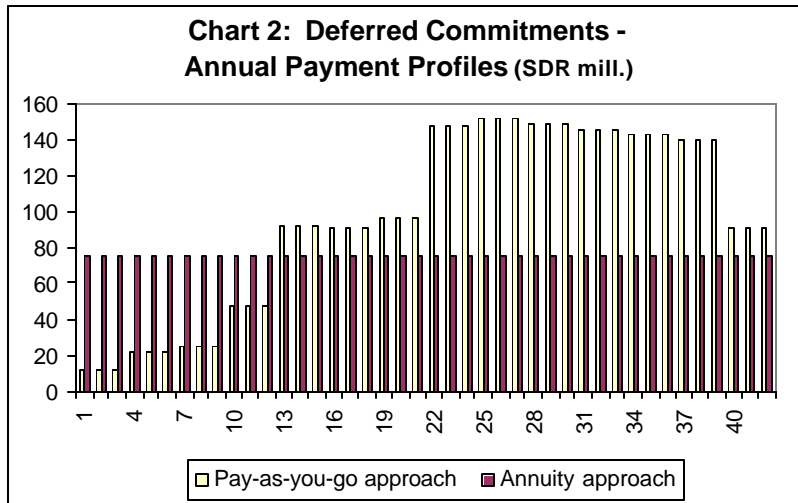
- b. Donors could also choose an ‘**annuity**’ approach whereby they would commit an equal, incremental amount over 14 replenishment cycles to cover the costs arising from IDA13 grants. The required commitment would amount to approximately **SDR 230 million per replenishment**, starting from IDA13. This is equivalent to a payment of SDR 76 million per annum over 40 years. The adoption of this funding mechanism would provide for a stable volume of commitments into the future, and would somewhat frontload delivery of the required amounts, relative to PAYG. Table 5 shows the incremental donor commitments per replenishment period and associated annual payments.

Table 5. Annuity Approach: Donor Commitments and Payments to Offset Loss of Reflows due to IDA13 Grants
(SDR million)

IDA Replenishment Period	IDA13	IDA14	IDA15	IDA16	IDA17	IDA18	IDA19	IDA20	IDA21	IDA22	IDA23	IDA24	IDA25	IDA26	Total
Commitment per IDA Period	228	228	228	228	228	228	228	228	228	228	228	228	228	228	3191
Fiscal Years	FY03-05	FY06-08	FY09-11	FY12-14	FY15-17	FY18-20	FY21-23	FY24-26	FY27-29	FY30-32	FY33-35	FY36-38	FY39-41	FY42-44	
Payments per Year ^{1/}	76	76	76	76	76	76	76	76	76	76	76	76	76	76	

1/ Assuming full encashment during each three-year replenishment period.

15. Chart 2 illustrates the annual payment profiles under both of the above scenarios in Option 2, over 40 years.



Option 3: Combining Upfront and Deferred Commitments

16. A third approach would be for Deputies to consider a combination of both of the above options. Under this approach, some of the lost reflows from IDA13 Grants would be committed and paid to IDA upfront, while other reflows would be committed and reimbursed at a later point in time.

17. The rationale for this approach is the fact that grant recipients are not required to pay charges while credit recipients are. Since the analytical, financial and operational services which the Bank provides to IDA countries are financed by IDA's charge structure, it can be argued that current borrowers under IDA credits effectively subsidize the recipients of IDA13 grants by paying service and commitment charges on credits. Option 3 would rectify this by reimbursing IDA upfront for such costs, the bulk of which are incurred early on. In contrast, lost reflows of principal could be reimbursed to IDA on a schedule reflecting when the actual cashflow losses are projected to occur, since this approach would effectively reinstate IDA's lending capacity as if IDA13 grants had been disbursed as credits.

18. To illustrate this approach, it is assumed that donors would make an upfront commitment – at the time of IDA14 – to reimburse IDA for the NPV cost of foregone service charge and commitment charge income due to IDA13 grants. This commitment under IDA14 would amount to about SDR 410 million (SDR 360 million for service charge and SDR 50 million for commitment charge), assuming a three-year encashment

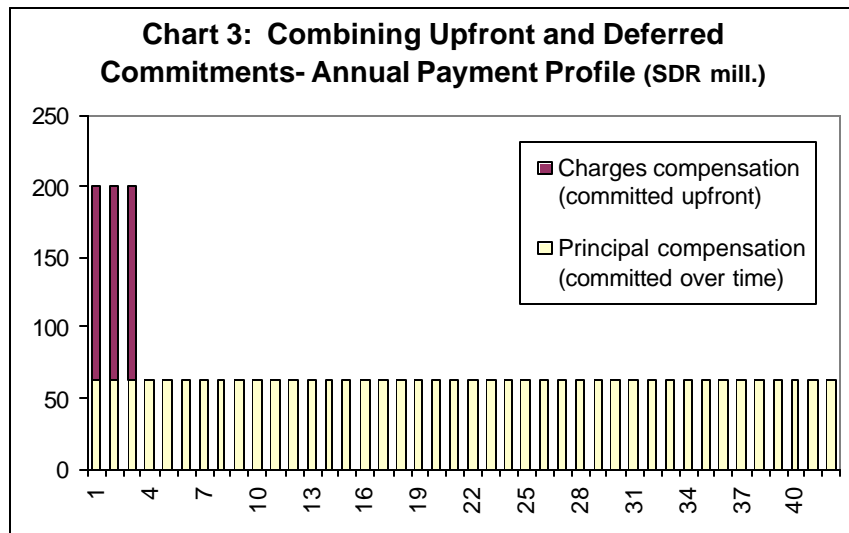
schedule. In addition, donors would commit to make available some SDR 190 million during IDA14, and they would also make available that same annuity amount of SDR 190 million during each future replenishment through IDA26, in order to compensate for the cost of lost principal reflows from IDA13 grants.

19. This approach would result in a total, incremental **donor commitment of about SDR 600 million during IDA14, with subsequent commitments of SDR 190 million per IDA replenishment, from IDA15 to IDA26.** These figures are shown in Table 6.

Table 6. Upfront Compensation for Charges and Annuity Compensation for Principal Reflows under IDA13 Grants
(SDR million)

	NPV of Lost Reflows as of FY06	IDA14 Commitment	IDA15 - IDA26 Commitments
Principal Repayments Lost	1,064	190	190
Service Charge Income Foregone	324	360	0
Commitment Charge Income Foregone	47	50	0
Total Cost of IDA13 Grants	1,436	600	190

20. Chart 3 illustrates the annual payment profile under this approach. Donors would pay SDR 200 million per annum during the first 3 years, and SDR 63 million per annum thereafter over 40 years. This assumes that donor commitments at each IDA replenishment will be encashed in three equal annual installments.



Cost of Grants Beyond IDA13

21. When considering the various options presented above, Deputies should consider the implications for future IDA replenishments if IDA continues to offer grants beyond the IDA13 period. Under Options 2 and 3, where future commitments would extend beyond the IDA14 replenishment cycle, cashflow costs for donors in outer years would rise

sharply. These future costs would arise in addition to existing funding issues relating to the HIPC initiative. Donors already have to manage the additional HIPC costs to IDA well into the next decade.

22. To illustrate this point for the PAYG mechanism under Option 2, Table 7 shows the cashflow costs to donors if IDA were to continue to offer 19.5% of its assistance in grant form beyond the IDA13 period.⁹ While the costs in early years are low, the required incremental contributions in 40 years' time could reach SDR 5.5 billion per replenishment, therefore accounting for an increasing share of total donor commitments in the future.¹⁰

Table 7. PAYG Approach: Required Additional Donor Contributions to Offset Loss of Reflows if IDA Provides 19.5% of Its Assistance in Grant Form from IDA13 and Onwards
(SDR million)

IDA Replenishment Period	IDA13	IDA14	IDA15	IDA16	IDA17	IDA18	IDA19	IDA20	IDA21	IDA22	IDA23	IDA24	IDA25	IDA26
Fiscal Year	FY03-05	FY06-08	FY09-11	FY12-14	FY15-17	FY18-20	FY21-23	FY24-26	FY27-29	FY30-32	FY33-35	FY36-38	FY39-41	FY42-44
Additional Contribution ^{1/2/}	40	110	200	300	600	1000	1300	1800	2400	3000	3600	4300	4900	5500

1/ Estimates rounded to the nearest 100 million from IDA15.

2/ Assuming full encashment during each three-year replenishment period.

23. The annuity approach has the same drawback that costs would rise sharply as more grants are delivered in successive replenishment periods. Table 8 illustrates the cost to donors under this approach over the next four decades under the assumption that IDA would deliver 19.5% of its assistance in grant form beyond IDA13. Costs would not rise as sharply as under the PAYG Mechanism, but would still reach SDR 3.3 billion per replenishment 40 years from today.

Table 8. Annuity Approach: Required Additional Donor Contributions to Offset Loss of Reflows if IDA Provides 19.5% of Its Assistance in the Grant Form from IDA13 and Onwards
(SDR million)

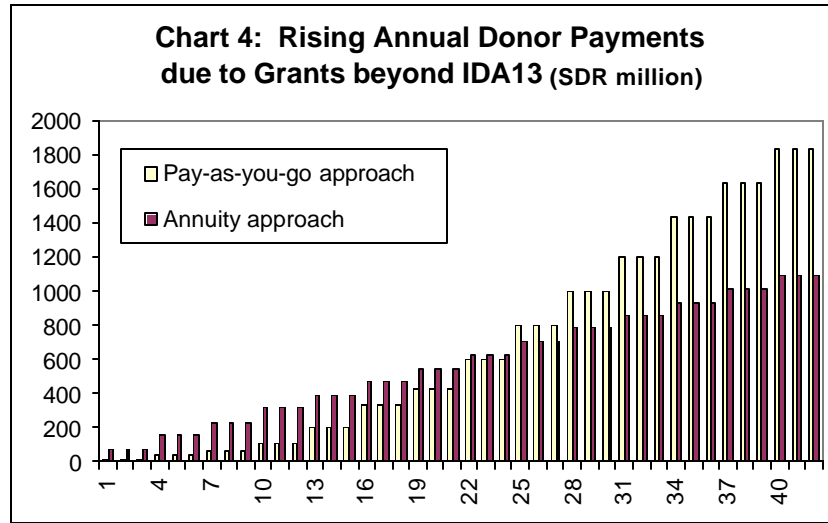
IDA Replenishment Period	IDA13	IDA14	IDA15	IDA16	IDA17	IDA18	IDA19	IDA20	IDA21	IDA22	IDA23	IDA24	IDA25	IDA26
Fiscal Year	FY03-05	FY06-08	FY09-11	FY12-14	FY15-17	FY18-20	FY21-23	FY24-26	FY27-29	FY30-32	FY33-35	FY36-38	FY39-41	FY42-44
Additional Contribution ^{1/}	230	465	699	934	1168	1403	1638	1872	2107	2341	2576	2811	3045	3280

1/ Assuming full encashment during each three-year replenishment period.

24. Chart 4 illustrates the associated annual payment profiles under Option 2 over 40 years, assuming the continued delivery of grants beyond IDA13.

⁹ It is assumed for illustrative purposes that IDA's volume of development assistance would grow by 2% per annum into the future.

¹⁰ Assuming that donor commitments remain constant in nominal terms from IDA13 on, grant compensation would account for 0.40% of donor commitments in IDA13, rising to 55% by IDA26.



25. The same issues arise under Option 3, as the bulk of the cost of IDA grants in the form of lost principal repayments would be committed and paid over a period of 40 years.

Conclusion

26. As the foregoing analysis demonstrates in some detail, the choices around the financing of grants are not easy, and have significant implications for the financial viability of IDA. While there is scope, as illustrated, for flexibility, in the timing of donor cash outlays to fulfill commitments made, it is apparent that protracted deferral of the commitments themselves may be seen as exposing IDA and its countries to significant financial risk. This argues for early and unambiguous commitment to the required resources. The possible build-up of future, incremental, donor commitments to offset the cost of grants made from future replenishments is a further reason for regarding one of the alternatives presented under Option 1 (upfront commitment by donors) as the first-best solution for financing IDA grants.