

International Finance Facility

a technical note

February 2003



HM TREASURY

DFID Department for
International
Development



International Finance Facility
a technical note

February 2003

© Crown copyright 2003.

Published with the permission of HM Treasury on behalf of the Controller of Her Majesty's Stationery Office.

The text in this document (excluding the Royal Coat of Arms and departmental logos) may be reproduced free of charge in any format or medium providing that it is reproduced accurately and not used in a misleading context. The material must be acknowledged as Crown copyright and the title of the document specified.

Any enquiries relating to the copyright in this document should be sent to:

HMSO
Licensing Division
St Clements House
2-16 Colegate
Norwich
NR3 1BQ

Fax: 01603 723000

e-mail: hmsolicensing@cabinet-office.x.gsi.gov.uk

HM Treasury contacts

To obtain further copies or for general enquiries, contact HM Treasury Public Enquiry Unit:

Tel: 020 7270 4558

Fax: 020 7270 4574

E-mail: public.enquiries@hm-treasury.gov.uk

Letters:
Public Enquiry Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

You can also find HM Treasury on the internet:
www.hm-treasury.gov.uk

DFID contacts

To contact DFID's Public Enquiry Unit:

Tel: 0845 3004100

From Overseas: +44 1355 84 3132

E-mail: enquiry@dfid.gov.uk

Letters:
Public Enquiry Unit
DFID
1 Palace Street
London
SW1E 5HE

You can also find DFID on the internet:
www.dfid.gov.uk

International Finance Facility - a technical note

MILLENNIUM DEVELOPMENT GOALS

1 The international community has agreed to meet the **Millennium Development Goals** (MDGs) by 2015. Meeting these goals by 2015 will help to ensure that every child receives a good, basic education; that child deaths are reduced by two thirds and maternal deaths by three quarters, as we combat HIV/AIDS and other diseases; and that the proportion of people without access to safe drinking water and sanitation is halved.

Aid finance

2 Progress in meeting these goals will substantially rest on the efforts of developing country governments to meet these goals, but developed countries must play their part too, through increased trade access, investment and substantially increased aid. According to best available estimates, meeting the MDGs could require an additional US \$50 billion each year in Overseas Development Assistance (ODA) or aid. Although these estimates are uncertain, the scale of the challenge is clear: it requires a near doubling of aid from current levels.

3 In 2001 donors provided \$52bn in ODA, equivalent to 0.22 per cent of their Gross National Income (GNI). The international community is committed to achieving the UN target of ODA reaching 0.7 per cent of GNI. In 2002 at Monterrey, pledges were made by the EU, US, and other donors that could provide \$12 billion a year of extra funding by 2006, but this still falls short of the sums needed to meet the MDGs by 2015.

Aid effectiveness and trade

4 In addition to securing additional resources, it is equally important to ensure that resources deliver value for money, focused on measurable outcomes in reducing poverty and investing in education, health and economic capacity. Further improvements in the effectiveness of aid and greater concentration of aid on poor countries will be needed to help meet the MDGs. Developing countries will need to put in place the conditions required to raise private investment levels and the policies required to secure economic stability, transparency, property rights and the rule of law. And in return the developed world must ensure that aid flows are predictable, stable, untied and long-term to allow for the effective and efficient planning necessary to achieve these goals. Developed countries must also provide greater trade access to world markets for poor countries.

Meeting the challenge

5 A number of proposals have been made for innovative and new ways to meet the challenge of raising additional finance and ensuring value for money. These range from the Tobin tax to new allocations of Special Drawing Rights by the IMF. But so far there is no international agreement on these proposals. And none of the proposals address the need for long-term predictability and increased aid effectiveness.

6 This paper sets out a proposal for an **International Finance Facility (IFF)**, designed to achieve both the additional finance and the value for money necessary to meet the MDGs. The Facility would - based on securitisation structures used in the capital markets - leverage in additional finance by borrowing through bonds issued in the international capital markets against long-term commitments for aid by developed countries. The IFF would essentially “frontload” long-term aid flows, raising sufficient finance to meet the MDGs by 2015.

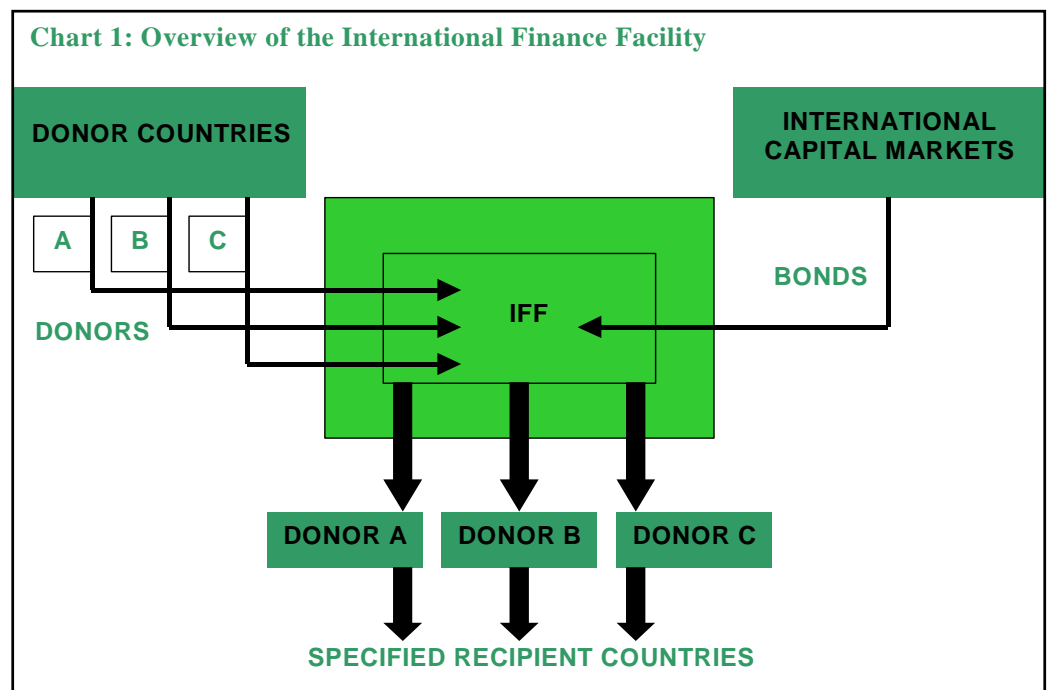
THE INTERNATIONAL FINANCE FACILITY

Overview

7 The Facility would be built on a series of long-term commitments from donor countries to make annual payments to the IFF. On the basis of these commitments, the Facility would leverage immediate, additional resources for aid by issuing bonds in the international capital markets.

8 The IFF would be a limited-life entity designed to use securitisation to frontload aid flows and so deploy a critical mass of development finance over the next 10 to 15 years to allow the MDGs to be met by 2015. We envisage its overall life would be around 30 years; the bulk of its disbursement would take place in the years up to 2015.

9 The IFF would seek to disburse its funds through existing effective bilateral and multilateral mechanisms. Funds relating to each donor’s commitment would be allocated by each donor to its choice of country and delivery channel, subject to a set of overarching principles – to be agreed by donors at the establishment of an IFF – to help ensure that funds raised through the Facility provide value for money.



10 The IFF would be an integral part of the new Monterrey Consensus, in which recipient countries commit to transparent and focused policies, priorities and processes for poverty reduction; and donors make long-term commitments to help secure the necessary resources and help poor countries use them effectively.

11 There are a number of advantages of the proposal for an IFF. In particular:

- it is focused on the financing necessary to help achieve the internationally agreed Millennium Development Goals;
- it is founded on developed countries' long-term commitments to those countries that are striving towards achieving the goals;
- it bridges the gap by leveraging these long-term commitments, enabling the 0.7 per cent target to be met sooner and allowing a substantial increase in aid when it will have the most impact on achieving the targets by 2015;
- it will allow a critical mass of aid to be linked up as a coordinated programme of sustained investment across health, education and other anti-poverty programmes;
- by crystallising long-term commitments from donors it can provide a predictable and stable flow of aid over the medium term to countries that remain committed to achieving the goals, thereby helping provide a catalyst for increased private investment;
- its structure encourages donor pooling and coordination, improving the effectiveness of aid. By bringing together donor flows and diversifying risk it is able to secure value for money; and
- it is based on a tried and tested principle for raising development finance.

The financing framework

The IFF's income

12 The primary source of the IFF's income would be annual payments from donors. Donors would commit, at regular intervals to multi-year, long-term 'streams' of annual payments to the IFF. These donor commitments would be legally binding, subject to one or two high-level financing conditions. The IFF would borrow against the security of this committed income stream.

Securitisation

13 By leveraging in private finance through issuing bonds in international capital markets, the IFF will transform a proportion – say 85 per cent of net-present-value - of this future income stream from donor countries into frontloaded capital available for more immediate disbursement. This securitisation process is common in international capital markets.

14 On the basis of each commitment by donors to provide a stream of annual payments to the Facility, the IFF would be able to issue bonds in international capital markets, to securitise the future flow of donor pledges and bring forward aid disbursement up to 2015. The creditworthiness of donors, the binding nature of their pledges and the financial strength of the Facility mean that the Facility should be able to borrow through bonds of the highest possible rating, reflecting the underlying quality of donor commitments.

15 This securitisation process will enable the IFF to raise a critical mass of funds to help achieve the MDGs by 2015. Disbursements of these funds will be made mainly in the years up to 2015. After that, the flow of funds committed to the IFF will be increasingly used to repay borrowing, so that the debt would be fully retired by around 2035.

16 The principle of leveraging funds through private borrowing in this way has long been part of the provision of development finance through the World Bank and other Multilateral Development Banks. The IFF will be based on this principle, but will apply it through a different, limited-life structure.

The donor commitment

17 The Facility would borrow on the basis of long-term donor commitments to provide streams of annual payments to the Facility. We envisage each ‘stream’ would comprise around 15 years of annual payments. Donors would ‘ earmark’ streams for individual recipient countries.

18 Donors would be legally bound to make the payments to the IFF in each stream which they had committed, subject to one or two high level ‘financing conditions’ linked to the recipient country for which that stream had been earmarked (see below). If a recipient country breached the financing conditions, donors would be able to suspend its payment streams earmarked for that country. But, unless the financing conditions had been breached, failure by a donor at any time to make any of the payments in a ‘stream’ to which it was committed would be viewed by financial markets as a sovereign default.

19 Donors would be ‘severally’ (i.e. individually), not jointly, liable for making their payments to the IFF. They would not have any responsibility for making good payments on which another donor had defaulted.

The ‘financing conditions’

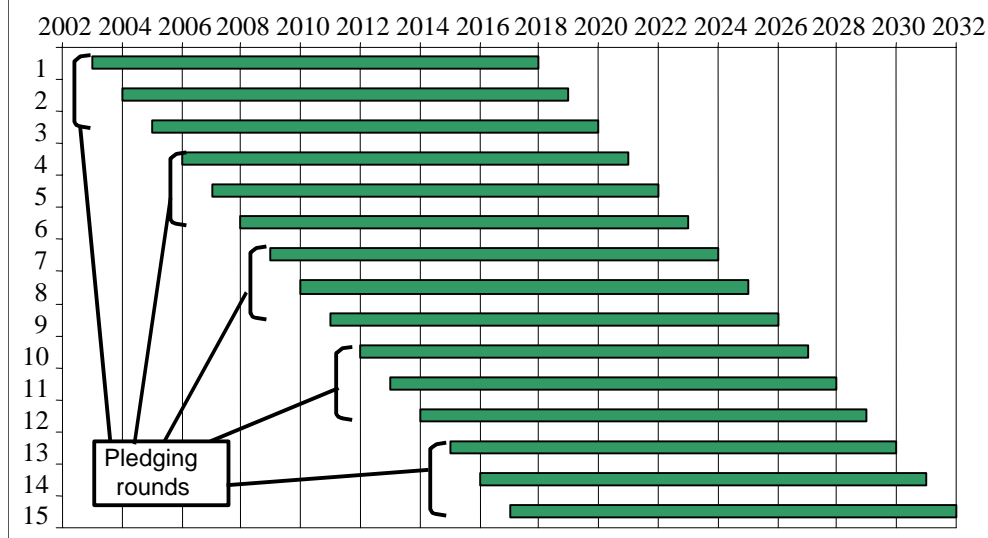
20 Donors would want to ensure that recipient countries met certain, fundamental, conditions, breach of which would make it impossible for the donor to continue to make the committed annual payments to the IFF in respect of that recipient. In order for bondholders to be clear about the risks to IFF income, these conditions would need to be few, very clearly defined in advance and capable of independent determination. Possibilities include the conditions that a recipient country did not fall into prolonged arrears with the IMF or did not become the subject of UN sanctions.

Regular ‘pledging rounds’

21 We envisage that donors would make fresh commitments to new batches of ‘streams’ of payments to the IFF at regular, say three-yearly, intervals. These regular ‘pledging rounds’ would build up a pattern of overlapping streams of payments to the IFF, though commitment in one pledging round would not bind a donor to committing in subsequent rounds. Chart 2 gives a stylised representation of this.

22 In this way, the income of the IFF would build up over its existence. On the simplified assumption that the IFF’s life would be thirty years and that total commitments of payment ‘streams’ were of equal value, the income would peak around the middle of the period. Disbursement would peak in the first ten years. Donors might, however, want to smooth their aggregate annual payments to the Facility, in which case the income would build up more slowly. Charts 3 and 4 offer illustrative examples of both income and disbursement patterns.

Chart 2: Stylised representation of donor commitments



Disbursement

23 The IFF would be a finance facility, not an agency for disbursement of development aid to recipient countries. It would therefore seek to disburse its funds through existing effective bilateral and multilateral mechanisms. This disbursement will be subject to certain overarching principles - to be agreed by donor countries when the IFF is established - that will help ensure the effectiveness of aid financed through the IFF.

24 Each donor would be responsible for deciding how to deploy the finance leveraged on the back of its individual commitments to make streams of annual payments to the IFF. Having raised funds collectively, we envisage that many donors will want to deploy the finance through multilateral channels or joint programmes. Individual donors may choose on a voluntary and several basis to use part of the funds for multilateral organisations such as the Global Health Fund or IDA. But there would be no obligation to do so.

25 Funds relating to each donor's commitment would be allocated by each donor to its choice of country and delivery channel. While each donor would be able to disburse the finance they had raised through the IFF at their discretion according to their conditionality and terms, there would be a set of overarching principles for all finance raised through the IFF.

26 The nature of these principles would be for agreement by donors at the establishment of the IFF. They could include, for example, conditions that funds must be:

- used for poverty reduction;
- not tied to contracts using suppliers from the donor country;
- provided in predictable multi-year programmes lasting at least 3 years;
- disbursed mainly in grant form, with some highly concessional loans;
- disbursed to a range of recipient countries so that no more than 5 per cent of the total amounts of finance raised through the IFF goes to any one country; and
- targeted at low-income countries.

Cost of financing

27 In order to frontload aid for disbursement in a cost-effective manner, it is important that the IFF is able to secure the highest possible rating for its bonds, reflecting the underlying credit quality of the donor commitments. The degree of leverage and the terms, on which the Facility could borrow, would depend on the level of perceived risk for bondholders. This would depend in turn on the probability that bondholders attach to the high-level financing conditions being met, and on the cautious limits that the Facility imposes on its borrowing.

28 In rating the credit quality of bonds issued by the IFF, financial rating agencies will look at the probability of recipient countries being in breach of the high-level financing conditions and, therefore, the probability that some of the payments pledged by donor countries to the IFF could be suspended. The higher the probability that recipient countries will breach the financing conditions and the greater the concentration of aid flows to recipients on a small number of countries, the lower the leverage that could be achieved by the IFF.

Bond markets

29 We believe borrowing by the IFF on the scale envisaged would not have an adverse effect on the cost of borrowing, because the international market for bonds similar to those the IFF would issue is very deep. In 2002 funding programmes in AAA bonds issued by US agencies (Fannie Mae, Federal Home Loan Bank, and Freddie Mac), along with KfW, the European Investment Bank, IBRD, the regional development banks and Cades totaled around \$1,060 billion, of which \$360 billion was in international capital markets.

Liability management

30 To secure and maintain the highest credit rating the IFF would need to manage its liabilities professionally. If the total stream of expected payments from donors was fairly regular, a constant profile of payments (interest and principal) to bondholders would be the closest match between its assets and liabilities. In practice, establishing a portfolio of bonds across the maturity spectrum and matching or hedging the currency composition of its liabilities would create a prudent and efficient financing profile, taking into account investor demand and the profile of donor flows to the IFF.

How the IFF could work

31 The degree of leverage achieved by the IFF would depend on the precise details of the Facility. For illustrative purposes, we set out below two possible profiles of donor payments, net borrowing and disbursements, on a range of realistic assumptions.

Two examples of IFF income and disbursement

Two examples illustrate the level of donor payments to the IFF needed, under different assumptions, to provide a substantial increase in aid flows.

Both examples assume that:

- disbursements from the IFF build up over 5 years to reach \$50 billion a year up to 2015, and then phase out over the subsequent 5 years;
- donors commit to annual payments to the IFF rising in line with their nominal Gross National Income (assumed to grow by 4 per cent a year); and
- the IFF borrows from international capital markets at a constant 5 per cent nominal interest rate.

Example A

To provide additional aid all in the form of grants:

- donors commit to annual payments to the IFF totaling around \$15 billion; and
- IFF stock debt peaks at around \$300 billion.

Example B

To provide additional aid 60 per cent as grants and 40 per cent as highly concessional loans:

- donors commit to annual payments to the IFF totaling around \$13 billion; and
- IFF stock debt peaks at around \$350 billion.

The financing framework

32 These examples assume that:

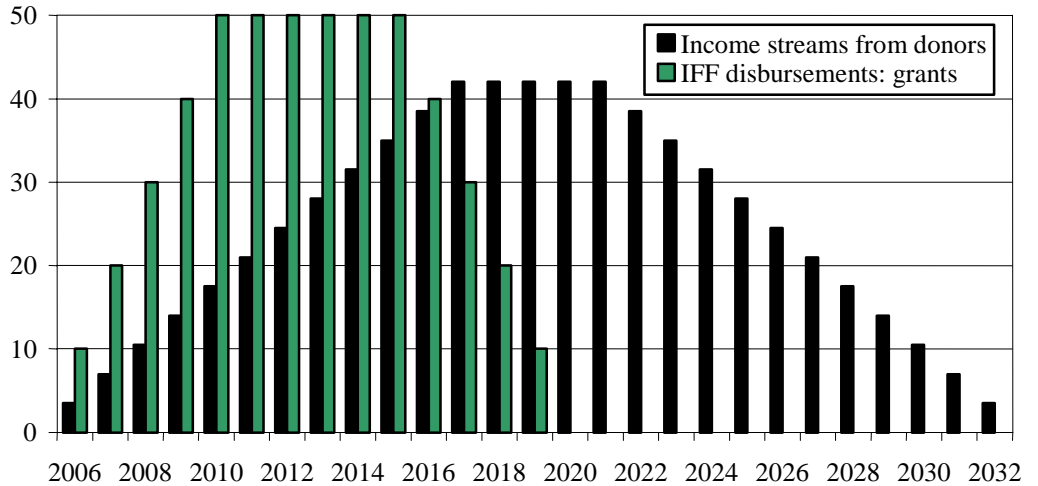
- the IFF does not securitise more than around 85 per cent of the net-present-value of its future income (the expected future stream of donor payments and, in example B, future repayments of highly concessional loans);
- donors commit to payments in support of a broad range of recipient countries, with no one country accounting for more than say 5 per cent of the total payments;
- as a result, the financing framework ensures that the overall risk of countries breaching the financing conditions is sufficiently low to make it highly likely that donor payments would be sufficient to meet the IFF's obligations to its bondholders; and
- the IFF therefore achieves a AAA credit rating for its bonds, so that it can borrow on equivalent terms to other multilateral agencies.

33 On the basis of these assumptions, the IFF would play a substantial part in helping to meet the MDGs. It would provide over \$500 billion in total aid, the bulk of it in the years up to 2015.

Distribution patterns

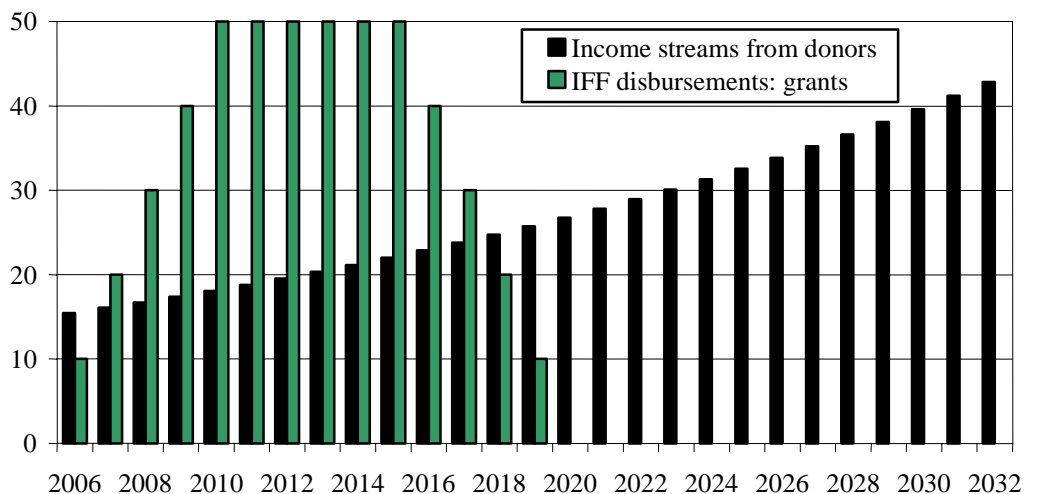
34 If donors commit to provide constant nominal streams of annual payments to the IFF (as in Chart 3 below), then the IFF’s aggregate income stream will increase uniformly, reaching a peak in the middle of the 30-year period and then decreasing uniformly.

Chart 3: Illustrative example of IFF income and disbursement patterns - constant nominal streams



35 We envisage, however, that donor commitments will be phased differently. It could be, for example, preferable for donors to commit to a more even spread of aggregate payments across the lifetime of the Facility, rising in line with donor income. Varying the value of donor commitments in this way would deliver the income and disbursement patterns shown in Chart 4 below.

Chart 4: Illustrative example of IFF income and disbursement patterns - phased streams



CONCLUSION

36 There are a number of advantages of the proposal for an International Finance Facility. By taking long-term aid commitments as its founding principle, it is able to leverage up resources to deliver a substantial increase in aid when it will have the most impact. It will also provide a critical mass of stable and predictable aid to be linked up in a coordinated programme of sustained investment across health, education and other anti-poverty programmes. In this way the Facility can achieve both additional finance and greater value for money.

37 Discussions with financial experts suggest the IFF is feasible, and sound precedents exist in structuring similar obligations in the private sector. We believe that a Facility along the lines outlined in this note could provide a realistic and achievable basis for not only doubling aid provided by the international community, but also ensuring that future aid flows are predictable and coordinated – fundamental preconditions to achieving the Millennium Development Goals by 2015.