

AID SECURITIZATION: BEYOND IFFIm

Suhas L Ketkar
Credit Capital Research

Main Messages

IFFIm has worked quite well since inception in 2006:

- Secured donor commitments of USD6.2 b
- raised USD3.6 b & disbursed USD1.8 b
- helped vaccinate more than 288 m children, saving more than five million lives

But scaling it up to fund education, climate change and other **development** initiatives could prove quite challenging

Securitization of future multilateral aid or south-south credit flows could be helpful, though some major implementation problems will have to be overcome

AMCs and Cash on Delivery are alternatives that are worth exploring

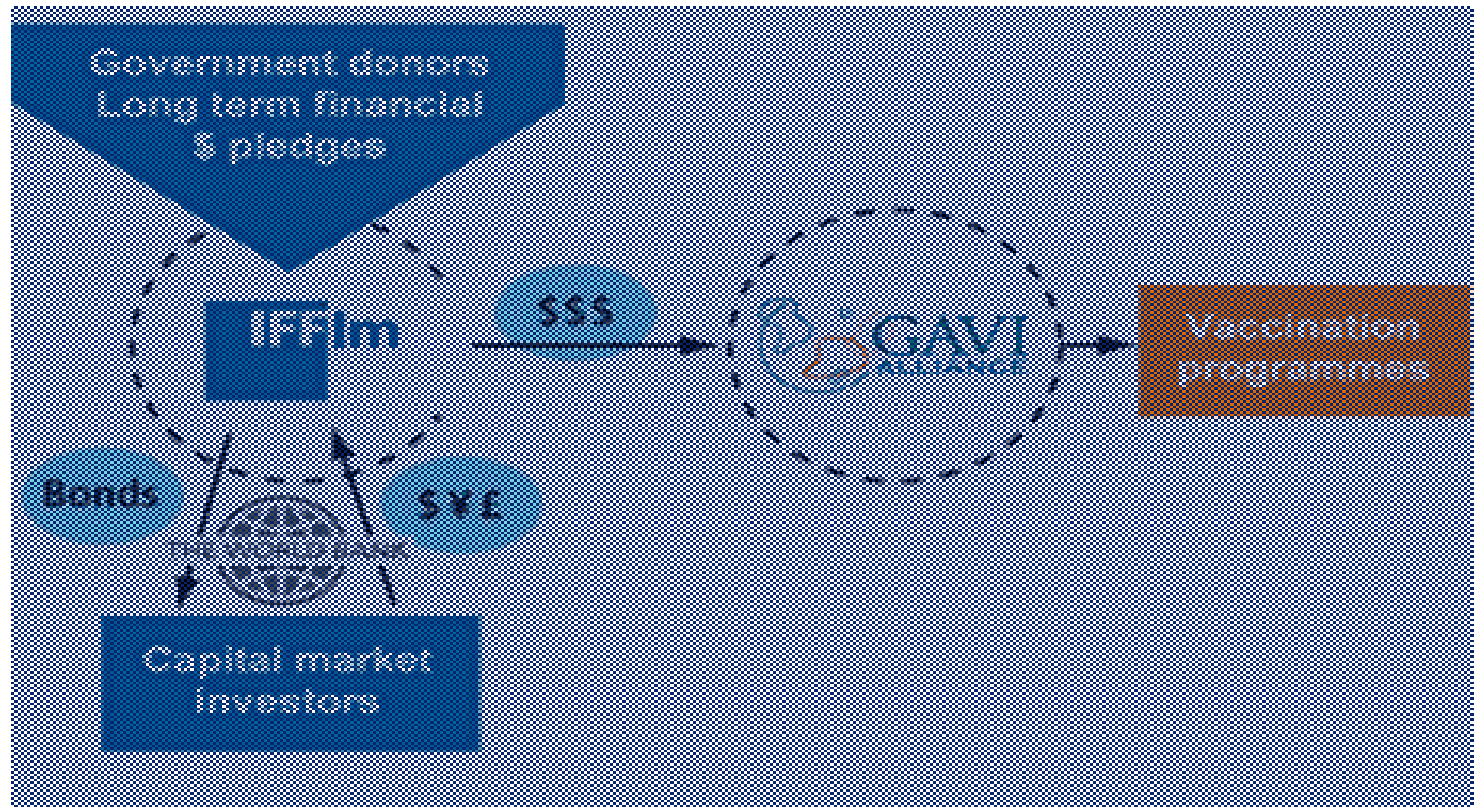
Agenda

Securitization embedded in IFFIm: its structure and unique features that resulted in rating agencies awarding it AAA credit rating

But risks to the AAA credit rating of IFFIm have risen in the current global environment and made it very unlikely that any new deals to fund education, climate change, and other development objectives will be rated AAA

Advanced Market Commitments (AMCs) and Cash on Delivery (COD) are alternatives to IFF and may be more useful for improving aid effectiveness without providing up-front funding

Structure of IFFIm



Unique Features of IFFIm

IFFIm meant:

- Predictable funding
- Significant front-loading of funding

Funding predictability brought in several benefits:

- increase in the likelihood of investment by companies in large-scale production capacity, thereby reducing costs
- raise the possibility of investment to increase coverage
- achievement of most efficient resource use over time

Front-loading can increase the spill-over benefits of immunization and bring in fiscal savings to developing country governments

IFFIm's AAA Credit Rating

AAA rating important to keep down costs of raising funds and to ensure that IFFIm continues to approve new Vaccination and Immunization (V&I) programs

Rating agencies perceived three credit risks to IFFIm notes:

- Donors honor their aid commitments in full and on time – this risk mitigated by (1) mostly I-grade donors and (2) compelling goal of supporting child V&I programs in poor countries
- IFFIm's treasurer fails in timely debt servicing – mitigated by WB as treasurer
- Several IFFIm-eligible countries run up protracted arrears to the IMF, the trigger used to release donors from a portion of their annual payments

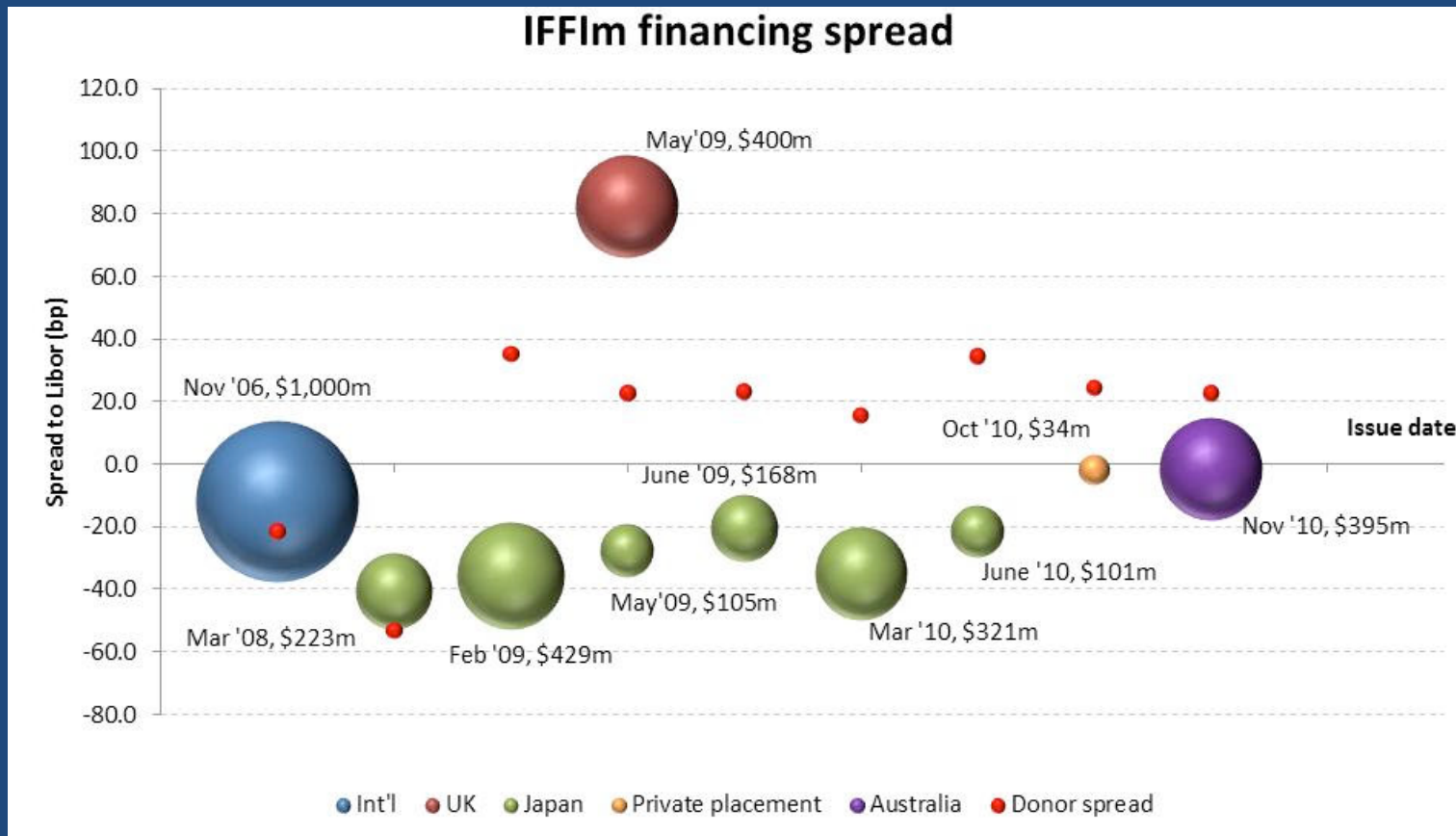
Importance AAA Credit Rating

Through March 2011, IFFIm has secured USD6.2 b in donor pledges from 11 donor countries

It has undertaken 19 bond issues in five markets, raising nearly USD3.6 b and disbursing through end 2010 USD1.8 b in 70 low-income countries, a testament to IFFIm's success in frontloading of resources

Overall, IFFIm has traded at a small premium to the World Bank and, in recent times, below the spread for the EIB and KfW; also in most cases IFFIm has priced inside the weighted average donor spread

Importance AAA Credit Rating



Source: Evaluation of the IFFIm, June 2011

But downgrade below AAA is no longer academic risk which brings into question IFFIm's ability to fund new programs

Scaling-up IFFIm

Needs for funding are massive, both in the context of specific MDGs as well as other development objectives

EFA has identified a funding gap of \$11 b per year if MDGs and EFA goals – universal primary education and elimination of gender gap - are to be met

This funding gap is some three-times the current level of ODA for education

Indeed, overall ODA has fallen way below target with the DAC delivering 56% of the pledged amount; its share of GNI in 2010 was at 0.31%, also way below the UN target of 0.7% of GNI

Scaling-up IFFIm

Hence, innovative ways of financing development are required

But is scaling-up IFFIm the answer?

Probably not because IFFIm's success is owed to many of its unique features which will be difficult, if not impossible, to replicate for other development goals in areas like education and climate change

Scaling-up IFFIm

IFFIm receives support from:

GAVI Alliance, a highly regarded public-private partnership, provides funds to purchase and deliver vaccines and also helps disburse IFFIm funds to eligible low-income countries

World Bank executes IFFIm's borrowing program and manages proceeds to ensure that sufficient liquidity is available to meet funding commitments

IFFIm also benefited from pro-bono legal and investment banking services

Scaling-up IFFIm

While some of this institutional support can be recreated for IFFs to fund other development goals, securing **credible** donor commitments could prove difficult

Rating agencies consider IFFIm commitments credible because :

- V&I programs are known to save lives and reduce debilitating disabilities
- Science supporting V&I programs is incontrovertible; V&I is recognized to be one of the most cost effective interventions

Rating agencies' belief about credibility of IFFIm commitments was validated when the UK government not only maintained but raised its commitment despite its budgetary problems

Scaling-up IFFIm

Unlike V&I programs, however, many development initiatives do not have universal appeal

While universal primary education and elimination of gender gap recognized as highly desirable goals, controversy surrounds on how best to achieve them

Even goals are controversial when it comes to climate change

Hence, risk of donors not paying their pledges in full and on time would rise in out years when grants are used to service debt

Scaling-up IFFIm

Front-loading via IFFIm is desirable because it permits low-income countries to clear up back-log of children who missed out on vaccinations, thereby saving millions of lives for V&I programs

Once the back-log is cleared to benefit from the “herd immunity” effect – disease eradication is the most extreme form of this benefit – the recurrent costs of V&I programs can be expected to decline

Even when IFFIm was conceived, aid commitments were expected to rise over time to provide funds to low-income countries to run permanent but smaller V&I programs

Scaling-up IFFIm

While front-loading in education would help build schools, the recurrent costs of providing education will be substantial

Inability of donor countries to raise funding commitments to education in future may then act as a constraint on furthering the cause of education in the long run if low-income countries are unable to raise resources to cover recurrent costs

Similar issues could come up in the context of other development initiatives

Scaling-up IFFIm

Some macro issues of relevance:

- AAA credit ratings of many developed countries are under stress since S and P downgraded US
- Any slippage in AAA credit ratings of Italy, France and the UK could result in rating agencies downgrading IFFIm given that their shares in total IFFIm pledges stand at 10.8%, 28.7% and 46.2%, respectively
- If two rating agencies were to rate IFFIm below AAA, IFFIm would not be able to fund new V&I programs
- In general, as more and more aid flows are pledged for scaling-up of IFFIm to promote other development goals, the credibility of all commitments is expected to decline, thereby adversely affecting the IFF ratings and borrowing costs

Scaling-up IFFIm

Yet another hurdle in scaling up IFFIm comes from the fact that many countries can not make off-budget multi-year aid commitments

In US context, Congress must provide appropriation covering full commitment amount before federal government can enter into legally binding contractual obligations

Indeed, all multi-year US development initiatives, including the much publicized USD15 b five-year Bush plan for HIV/AIDS relief, are contingent upon Congressional appropriations over time

Scaling-up IFFIm

While lack of consensus on scientific merits of climate change can create an obstacle to IFF for the purpose, a facility to reduce global (as opposed to local) pollution may hold a special appeal to donor nations

Benefits from reducing global pollution accrue to citizens of the world, including those living in donor countries

Donor countries may then find IFF for reducing global pollution the most cost effective method of achieving certain global climate change outcomes

Scaling-up IFFIm

As ODA from emerging donor countries -- China, Brazil, India, South Africa and others – has increased from about 5% of total ODA to nearly twice that level at present, opportunities for their involvement in IFFs has gone up

South Africa and Brazil have pledged USD20 m each to IFFIm

But given emerging donors interest in securing access to raw materials and markets in low-income countries, IFFs directed at infrastructure may prove more attractive to them

Alternatives to IFFIm

Advanced Market Commitment (AMC) is another mechanism for creating sufficient market certainty to incentivize production capacity and/or R&D

Example: In 2007, five donor governments (Canada, Italy, Norway, Russia, and the United Kingdom) and Bill & Melinda Gates Foundation committed USD1.5 b to accelerate development of commercially viable new pneumococcal vaccine for developing countries

This mechanism promotes financing predictability, but leads to no front loading

Rating issues don't arise, but future commitments can raise budget scoring problems

Alternatives to IFFIm

Cash on Delivery (COD) is yet another alternative in which donors commit to pay for example USD100 for each additional child who completes primary school and takes a standardized competency test

Since donor disbursements would occur following independent certification of outcomes, COD assures aid effectiveness

Since COD utilizes developing countries' existing budget and procurement systems, it aids growth in local capacity but at a potential risk of corruption

COD provides neither predictable nor up-front funding but improves aid effectiveness

Wrap-up

While IFFIm has been quite successful, scaling it up raises many questions:

- Will donor commitments be as credible as those for V&I programs?
- Will donor pool retain AAA ratings so that IFFs will also be rated AAA?
- Will replicating IFFIm for other initiatives dilute donor commitments?
- Will budget scoring issues limit number of donors?

South-South aid securitization for infrastructure projects and alternative mechanisms like AMC and COD programs could be used