FOR AGENDA

SM/09/35
Correction 1

February 23, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Review of Fund Facilities—Analytical Basis for Fund Lending and Reform Options**

The attached corrections to SM/09/35 (2/6/09) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 5, footnote 1: for "U. Ramakrishnan, A. Stuart, W. McGrew, H. Finger (MCD)" read "U. Ramakrishnan, A. Stuart, W. McGrew, I. Halikias, G. Adler, and M. Goretti (SPR); and H. Finger (MCD) under the guidance of R. Weeks-Brown (LEG), A. Ghosh and J. Ostry (RES), and L. Giorgianni (SPR)."

Pages 41-44, Table II.1. Lending Instruments of Other MDBs and IFIs Comparable to the IMF: replaced.

Questions may be referred to Mr. Giorgianni, SPR (ext. 35326).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (5)

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Department Heads

I. INTRODUCTION[1]

1. One of the purposes of the Fund is to provide financial assistance, under adequate safeguards, to members facing BOP problems. Fund lending contributes to global financial stability by mitigating the risk that members' problems erupt into full crisis and spill over into other countries through contagion. While most emerging market countries have increased their resilience to shocks over the past decade by accumulating foreign exchange reserves, improving policies, and building stronger institutions, the recent global financial turmoil has underscored the need to take a fresh look at the underpinnings of the Fund's lending toolkit that was put in place several decades ago.

2. At the Executive Board discussion of the *Review of the Fund's Financing Role in Member Countries* (the *chapeau paper*, SM/08/283 and SM/08/283, Sup. 1), Directors called for an exploration of the analytical basis of Fund lending, looking at a range of issues such as the nature of market gaps and the Fund's role in filling them, the coherence and completeness of the Fund's lending toolkit, the relevance of the BOP criterion for lending in today's globalized world, and the purpose and modalities of conditionality and the room for increasing its flexibility and focus. This and the companion paper on *Conditionality in Fund-Supported Programs—Purposes, Modalities, and Options for Reform* (the *conditionality paper*, SM/09/30) respond to that request. Additional issues related to the review of access limits and financing terms in the GRA and of the lending role and facilities for low-income countries (LICs) are covered in separate papers.

3. A number of factors point to the inadequacy of the Fund's lending toolkit—notwithstanding the recent surge in demand for Fund resources. Among these, members' efforts at self-insurance through the accumulation of foreign reserves, the increased demand for alternative sources of BOP support (regional reserve pools, bilateral swap, and lending arrangements, and even competing facilities offered by MDBs and other IFIs), and the evolution of crises from mainly current account- to complex capital account-centered events. To this end, laying out the analytical basis for Fund lending is important to help guide reforms of the Fund's instruments in a way that leverages the Fund's comparative advantages and is responsive to the evolving needs of its members. Drawing on this analysis—and staff's informal consultations with academics, market participants, and policymakers—options are presented on adapting the Fund's lending instruments to the evolving global economy.

4. The rest of this paper is organized as follows. Section II discusses the analytical basis of the Fund's crisis lending role—why the Fund has a niche in lending for crisis prevention and resolution relative to private creditors or other sources. Against this background,

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[1] This paper was prepared by a team comprising C. Ogada, Y. Liu, and W. Bossu (LEG); J. Roaf and Y. Lu (MCM); R. Bi, M. Chamon, J. Kim, R. Ranciere, and L. Ricci (RES); and U. Ramakrishnan, A. Stuart, W. McGrew, I. Halikias, G. Adler, and M. Goretti (SPR); and H. Finger (MCD) under the guidance of R. Weeks-Brown (LEG), A. Ghosh and J. Ostry (RES), and L. Giorgianni (SPR).

Section III reviews the experience and implications of Fund lending for crisis prevention and resolution. Section IV discusses the BOP need criterion. Section V considers options for introducing new instruments and modifying existing facilities and lending policies. Section VI presents the issues for discussion.

II. The Basis for Fund Crisis Lending: Analytical Considerations

5. Under the Articles of Agreement, the Fund makes its general resources "temporarily available to [members] under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." Fund financing is thus premised on the member having a BOP need and implementing policies that, with Fund support, will help resolve its BOP problems. In turn, this implies an important catalytic role for Fund lending in marshalling new financing, facilitating debt restructuring, or underpinning confidence to help prevent outflows.

6. But why does the Fund have a crisis-lending role relative to other lenders? In tackling this question, it should be recognized that a country with BOP needs might face a continuum of situations between crisis prevention, mitigation, and resolution. At one end are countries with strong policies and fundamentals that may nonetheless face *liquidity* problems. In such situations, Fund lending through a contingent credit line or a short-term liquidity window, without necessarily requiring policy adjustment, could help *prevent* incipient liquidity problems from developing into solvency problems and a full-blown debt run.

7. At the other end of the spectrum are cases where poor policies or longer-lasting shocks mean that the country needs to undertake external and policy adjustment (and/or a restructuring of its external obligations) in order to restore *solvency*.[2] Crisis *resolution* lending by the Fund requires the member to credibly commit to such an adjustment path while reducing the risk/size of withdrawals of private financing that would force *excessive* external adjustment—i.e., beyond that required for medium-term debt sustainability.

8. Along this spectrum, Fund lending is likely to play a crisis prevention-resolution role by: (i) providing contingent support to countries, giving an incentive for stronger crisis prevention policies; (ii) providing liquidity, reducing the likelihood of a creditor run on the country (that, in turn, would involve "value destroying" liquidation of investments), and cushioning the requisite adjustment if a liquidity run nevertheless develops; (iii) conditioning its support, providing the country with a policy commitment device; and (iv) putting its own money on the line, strengthening the policy signal to markets.

The Fund's role is buttressed by three characteristics: (i) its ability to provide *large-scale financing* in crisis situations when there are strong pressures for the private sector to exit, thus helping to avert a run by private creditors; (ii) its ability to agree *conditionality* with the

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[2] That is, to satisfy the intertemporal budget constraint without an implausibly large future adjustment.

Table II.1. Lending Instruments of Other MDBs and IFIs Comparable to the IMF

MDB	Type of the instrument	Type of support	Purpose	Conditionality	Eligibility and Access Level	Financial terms and conditions
World Bank (IBRD)	Development policy lending (DPL) for IBRD borrowers	Budget Support	Supports reform programs in IBRD countries.	Prior actions and triggers mutually agreed upon with government.	IBRD countries. The level of access consistent with relevant country partnership strategy (CPS).	Maturity limit on all IBRD loans up to 18 years and a final maturity limit for blend instruments up to 30 years; usually provided as Fixed Spread Loan (FSL) or variable spread loans (VSL). **FSL.** The initial interest rate on FSLs consists of (a) a variable base rate of six-month LIBOR in respect of each interest period for each loan; and (b) a spread, fixed for the life of the loan. **Variable spread loans(VSL).** The lending rate on VSLs consists of: (a) a variable base rate of six-month LIBOR in respect of each interest period for each loan; and (b) a variable spread.
	1. Programmatic support/DPL		Address actual or anticipated development financing requirements of domestic or external origin.	Typically, all DPL Board packages are expected to reflect IMF views, including through a separate annex (either the PIN from a program review or Article IV Consultation conducted within the last six months before the time of Board submission or an IMF Assessment Letter).		
	2. Supplemental financing	IMF-supported program required	Countries already implementing DPL-supported program and facing an unanticipated shock, which can jeopardize program implementation and can result in an urgent and unexpected financing gap (resulting from commodity price shocks, natural disasters, etc.).	No prior actions and triggers additional to those in the original DPO.	Countries already implementing a DPL-supported program.	

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IBRD (cont.)	*3. Special DPL*	Part of international support package	For IBRD-eligible countries that are approaching or are in a crisis with substantial structural and social dimensions, and that have urgent and extraordinary financing needs, the Bank may, on an exceptional basis, provide special DPL beyond the level set out in the CAS.		All IBRD-eligible countries. Part of an international support package (including a disbursing IMF-supported program).	Special DPL Terms are currently: Front-end Fee: 100 bps Minimum Interest rate: LIBOR+400 bps.
	4. *DPLs with deferred drawdown option (DPL-DDO)* (applicable with all above instruments)	Precaution-ary	Address the needs of Bank clients that are accessing capital markets for a large part of their funding needs and do not foresee the need for immediate IBRD disbursements. The DPL DDO provides access to IBRD advisory support and serves as a risk management tool to support structural programs in the event of an unexpected funding need.	The same as for all DPLs. Periodic monitoring of prior actions and key conditionalities required. The loan proceeds may be drawn down at any time during the three-year drawdown period unless the Bank has notified the borrower that one of the drawdown conditions (e.g., adequate macro framework, prior actions under the program, etc.) is not being met.	All IBRD members	*IBRD lending offers a borrowing option called deferred drawdown option (DDO), which allows* the IBRD borrowers to postpone disbursement of a loan for a defined period, instead of drawing down funds immediately after approval. Key features of DPL DDO: (i) the borrower may defer disbursement of a DPL for up to three years, renewable for an additional three years; and (ii) during the period in which resources remain undrawn, an annual fee on 0.25 percent of the undrawn balance is charged.
IFC	Expanded trade finance program; Bank Recap Fund; Infrastructure Crisis Facility	Lending to selected companies/ institutions	Launched or expanded facilities to address crisis-related problems faced by the private sector, critical to employment, recovery, and growth.	N/A	Members of the World Bank Group	Financing is expected to total about $30 billion over the next three years; this total includes IFC funds as well as money mobilized from other sources, including governments and other IFIs.

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Inter-American Develop-ment Bank (IDB)	*1. Emergency Lending*	Budget support; requires IMF-supported program	Fast-disbursing emergency lending, as part of an international effort to provide support for structural and social reforms. To mitigate effects of crisis on vulnerable groups, protect financing of selected social programs.	Must fit within a macro stabilization program endorsed by the IMF; policy matrix required.	Creditworthy borrowers potentially in crisis, and with exceptional financing needs.	Disbursement periods can range up to 18 months. US$ finding with interest rate tied to the six-month U.S. dollar LIBOR rate, plus 400 bps. They have a five-year term and a three-year grace period.
	2. Liquidity Program for Growth Sustainability (2008). Expires December 2009	Investment lending	Provide liquidity to regulated financial institutions facing reduced access to foreign credit, so that they can provide trade credit to domestic exporters and producers, and maintain firms' access to working capital. To offset temporary impact of external credit shock).	Require a Fund Article IV Consultation within the last 18 months and an assessment letter at the time of consideration of the loan.	All sovereign borrowers or borrowers with a sovereign guarantee are eligible to borrow from the ordinary capital of the Bank could participate in the program up to $500 million per country.	Disbursement periods can range up to 18 months. US$ finding with interest rate tied to the six-month U.S. dollar LIBOR rate, plus 400 bps. Five-year term and a three-year grace period.
	3. *Policy-Based Loans* (or Sector Adjustment Loans)	Budget support	Multi-Tranche PBL: support for institutional and policy changes, through fast-disbursing funds. Programmatic PBL: Phased support to a multiyear program of policy reforms and institutional change, through fast-disbursing funds.	Multi-Tranche PBL: Approval of a loan with multiple tranches, each disbursed after verifying completion of conditions. 12-47 conditions (sample from 2000-02 PBLs). Programmatic PBL: Approval of a series of operations that are each disbursed in a single tranche upon achievement of pre-		Ordinary Capital: (i) Pool-based adjustable lending rate option: The interest rate is tied to the average cost of a pool of medium to long-term borrowings in each loan currency plus the IDB´s standard lending spread for that semester. Amortization may go from 15 to 25 years. (ii) LIBOR-based lending rate option: The interest rate is based on three-month LIBOR in the loan currency, plus a cost margin plus the IDB's standard lending spread. Amortization is 15 to 25 years. Fund for Special Operations

IDB (Contd.)				established triggers.		(concessional financing): 40 year amortization period, 10 year grace period, interest rate 1% for 10 years, 2% thereafter. FSO resources are available to countries with a GDP per capita below $2,193 through a blend of OC and FSO in predetermined ratios.
Asian Develop-ment Bank (ADB)	Special Program Loan (SPL)	BOP and budget support; part of an international support package that may include the IMF.	Address crisis situations (e.g., large reversals of capital flows and unexpected swings in relative prices) by providing large-scale lending as part of an international package, usually including IMF and World Bank. Short-term time horizon, large size, quick disbursing (up to three years), nonstandard lending terms, and focus on reducing severity of the crisis.	Broad-based sector reform/development plan that will lift efficiency and performance, comprising in particular policy changes and institutional enhancement, is the basis for program lending. Plan is set forth in a policy statement by the DMC government concerned.	To avail of the SPL, a DMC must be Ordinary Capital Resource (OCR) eligible. Countries that have graduated out of regular ADB assistance are eligible for SPLs.	For all program lending, there are no individual country ceilings. Total annual program lending cannot exceed 20% of total lending on a 3-year moving average basis. Maturity period of an SPL is five years including a grace period of three years. The floor for SPL charges is 400 basis points above LIBOR, and the spread is fixed for the life of the loan. In addition, such other charges as are applicable to regular OCR loans also apply to SPLs.
EBRD	Investment lending for crisis response: *Corporate Support Facility* (ST refinancing, working capital); *Trade Finance Program* (liquidity, bank guarantees); *Bank Recap. Program* (equity, sub-debt); *Unfunded Risk Participations* (syndications)	Investment lending, equity, working capital and commercial funds mobilization	To support bank balance sheets and corporate sector investment financing and working capital, and to ensure that financing flows (including trade) are not disrupted at times of severely restricted access to finance.	Predominantly private sector operations. Public sector loans (ca. 25 percent of volume) can carry sector policy conditionality. Policy dialogue on bank restructuring and capital market regulation).	30 EBRD member countries; target signings 2009 €7 billion. The scale of operations varies case-by case, mostly in the range $10–50 million and up to a maximum of around $250 million per transaction.	Lending terms client driven, but generally linked to a floating rate such as LIBOR. Local currency lending encouraged where local reference rate (e.g., MosPrime, KievPrime). Equity terms individually negotiated; quasi-equity usually floating rate basis with a cap or a collar.